

EAGLE FINANCIAL SERVICES INC  
Form 10-Q  
November 10, 2008  
Table of Contents

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

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2008

or

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-20146

**EAGLE FINANCIAL SERVICES, INC.**

(Exact name of registrant as specified in its charter)

Virginia  
(State or other jurisdiction of incorporation or organization)

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

2 East Main Street

22611

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

**P.O. Box 391**

**Berryville, Virginia**  
(Address of principal executive offices)

**(540) 955-2510**

(Zip Code)

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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.

Large accelerated filer   
Non-accelerated filer

Accelerated filer   
Smaller reporting company

(Do not check if a smaller reporting company.)

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

The number of shares of the registrant's Common Stock (\$2.50 par value) outstanding as of November 1, 2008 was 3,159,060.

**Table of Contents**

**TABLE OF CONTENTS**

**PART I FINANCIAL INFORMATION**

|         |   |    |
|---------|---|----|
| Item 1. | <u>Financial Statements:</u>  |    |
|         | <u>Consolidated Balance Sheets at September 30, 2008 and December 31, 2007</u>  | 1  |
|         | <u>Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2008 and 2007</u>                | 2  |
|         | <u>Consolidated Statements of Changes in Shareholders' Equity for the Nine Months Ended September 30, 2008 and 2007</u> | 3  |
|         | <u>Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007</u>                      | 4  |
|         | <u>Notes to Consolidated Financial Statements</u>   | 6  |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                            | 14 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u>   | 23 |
| Item 4. | <u>Controls and Procedures</u>  | 23 |

**PART II OTHER INFORMATION**

|          |  |    |
|----------|--|----|
| Item 1.  | <u>Legal Proceedings</u>   | 24 |
| Item 1A. | <u>Risk Factors</u>  | 24 |
| Item 2.  | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 24 |
| Item 3.  | <u>Defaults Upon Senior Securities</u>                             | 24 |
| Item 4.  | <u>Submission of Matters to a Vote of Security Holders</u>         | 24 |
| Item 5.  | <u>Other Information</u>   | 24 |
| Item 6.  | <u>Exhibits</u>  | 24 |

**Table of Contents****PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****EAGLE FINANCIAL SERVICES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets**

(dollars in thousands, except share amounts)

|   | September 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|---|--------------------------------------|----------------------|
| <b>Assets</b>   |                                      |                      |
| Cash and due from banks   | \$ 8,598                             | \$ 13,568            |
| Federal funds sold  |                                      |                      |
| Securities available for sale, at fair value  | 94,879                               | 54,717               |
| Securities held to maturity (fair value: 2007, \$29,391)  |                                      | 29,520               |
| Loans, net of allowance for loan losses of \$3,911 in 2008 and \$3,191 in 2007                                      | 387,478                              | 386,470              |
| Bank premises and equipment, net  | 15,544                               | 16,507               |
| Other assets  | 8,532                                | 6,769                |
| <b>Total assets</b>   | <b>\$ 515,031</b>                    | <b>\$ 507,551</b>    |
| <b>Liabilities and Shareholders Equity</b>  |                                      |                      |
| <b>Liabilities</b>  |                                      |                      |
| Deposits:   |                                      |                      |
| Noninterest bearing demand deposits   | \$ 85,083                            | \$ 81,763            |
| Savings and interest bearing demand deposits  | 143,173                              | 146,766              |
| Time deposits   | 138,770                              | 151,056              |
| <b>Total deposits</b>   | <b>\$ 367,026</b>                    | <b>\$ 379,585</b>    |
| Federal funds purchased and securities sold under agreements to repurchase  | 19,362                               | 12,983               |
| Federal Home Loan Bank advances   | 75,000                               | 60,000               |
| Trust preferred capital notes   | 7,217                                | 7,217                |
| Other liabilities   | 2,407                                | 2,588                |
| Commitments and contingent liabilities  |                                      |                      |
| <b>Total liabilities</b>  | <b>\$ 471,012</b>                    | <b>\$ 462,373</b>    |
| <b>Shareholders Equity</b>  |                                      |                      |
| Preferred stock, \$10 par value; 500,000 shares authorized and unissued   | \$                                   | \$                   |
| Common stock, \$2.50 par value; authorized 10,000,000 shares; issued 2008, 3,159,060; issued 2007, 3,130,801 shares | 7,859                                | 7,798                |
| Surplus   | 7,620                                | 7,153                |
| Retained earnings   | 31,600                               | 30,832               |
| Accumulated other comprehensive income  | (3,060)                              | (605)                |
| <b>Total shareholders equity</b>  | <b>\$ 44,019</b>                     | <b>\$ 45,178</b>     |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 515,031</b>                    | <b>\$ 507,551</b>    |

See Notes to Consolidated Financial Statements

**Table of Contents****EAGLE FINANCIAL SERVICES, INC.****Consolidated Statements of Income (Unaudited)**

(dollars in thousands, except per share amounts)

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|--|---------------------------|-------------|--------------------------|-------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|  | <b>2008</b>               | <b>2007</b> | <b>2008</b>              | <b>2007</b> |
| <b>Interest and Dividend Income</b>  |                           |             |                          |             |
| Interest and fees on loans   | \$ 6,133                  | \$ 6,882    | \$ 18,818                | \$ 20,404   |
| Interest on federal funds sold   | 7                         | 23          | 43                       | 101         |
| Interest on securities held to maturity:   |                           |             |                          |             |
| Taxable interest income  |                           | 7           |                          | 25          |
| Interest income exempt from federal income taxes                                       |                           | 272         |                          | 778         |
| Interest and dividends on securities available for sale:                               |                           |             |                          |             |
| Taxable interest income  | 724                       | 600         | 2,009                    | 1,792       |
| Interest income exempt from federal income taxes                                       | 284                       | 28          | 871                      | 86          |
| Dividends  | 149                       | 66          | 550                      | 182         |
| Interest on deposits in banks  | 1                         | 1           | 4                        | 5           |
| Total interest and dividend income   | \$ 7,298                  | \$ 7,879    | \$ 22,295                | \$ 23,373   |
| <b>Interest Expense</b>  |                           |             |                          |             |
| Interest on deposits   | \$ 1,618                  | \$ 2,682    | \$ 5,427                 | \$ 8,194    |
| Interest on federal funds purchased and securities sold under agreements to repurchase | 132                       | 87          | 369                      | 190         |
| Interest on Federal Home Loan Bank advances  | 672                       | 609         | 2,036                    | 1,698       |
| Interest on trust preferred capital notes  | 77                        | 127         | 266                      | 443         |
| Total interest expense   | \$ 2,499                  | \$ 3,505    | \$ 8,098                 | \$ 10,525   |
| Net interest income  | \$ 4,799                  | \$ 4,374    | \$ 14,197                | \$ 12,848   |
| <b>Provision For Loan Losses</b>   | 710                       | 75          | 1,210                    | 225         |
| Net interest income after provision for loan losses                                    | \$ 4,089                  | \$ 4,299    | \$ 12,987                | \$ 12,623   |
| <b>Noninterest Income</b>  |                           |             |                          |             |
| Income from fiduciary activities   | \$ 207                    | \$ 215      | \$ 700                   | \$ 704      |
| Service charges on deposit accounts  | 629                       | 579         | 1,766                    | 1,662       |
| Other service charges and fees   | 664                       | 779         | 2,092                    | 2,047       |
| Gain on the sale of loans  |                           |             | 376                      |             |
| Gain on the sale of bank premises and equipment  |                           |             | 742                      |             |
| Gain (loss) on the sale of other real estate owned                                     | (70)                      |             | (70)                     |             |
| Gain (loss) on securities  | (2,488)                   |             | (2,488)                  |             |
| Other operating income   | 23                        | 44          | 238                      | 251         |
| Total noninterest income   | \$ (1,035)                | \$ 1,617    | \$ 3,356                 | \$ 4,664    |
| <b>Noninterest Expenses</b>  |                           |             |                          |             |
| Salaries and employee benefits   | \$ 2,329                  | \$ 2,324    | \$ 6,947                 | \$ 6,802    |
| Occupancy expenses   | 256                       | 294         | 901                      | 854         |
| Equipment expenses   | 173                       | 197         | 519                      | 569         |
| Advertising and marketing expenses   | 113                       | 133         | 291                      | 337         |
| Stationery and supplies  | 51                        | 94          | 244                      | 253         |

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

|                                      |            |          |           |           |
|--------------------------------------|------------|----------|-----------|-----------|
| ATM network fees                     | 126        | 145      | 341       | 322       |
| Other operating expenses             | 1,073      | 914      | 2,826     | 2,487     |
| Total noninterest expenses           | \$ 4,121   | \$ 4,101 | \$ 12,069 | \$ 11,624 |
| Income before income taxes           | \$ (1,067) | \$ 1,815 | \$ 4,274  | \$ 5,663  |
| <b>Income Tax Expense</b>            | 363        | 522      | 1,934     | 1,626     |
| Net income (loss)                    | \$ (1,430) | \$ 1,293 | \$ 2,340  | \$ 4,037  |
| <b>Earnings Per Share</b>            |            |          |           |           |
| Net income per common share, basic   | \$ (0.45)  | \$ 0.42  | \$ 0.75   | \$ 1.30   |
| Net income per common share, diluted | \$ (0.45)  | \$ 0.42  | \$ 0.75   | \$ 1.30   |

See Notes to Consolidated Financial Statements

**Table of Contents****EAGLE FINANCIAL SERVICES, INC.****Consolidated Statements of Changes in Shareholders Equity (Unaudited)**

(dollars in thousands, except share and per share amounts)

|  | Common<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Comprehensive<br>Income | Total     |
|--|-----------------|----------|----------------------|---|-------------------------|-----------|
| <b>Balance, December 31, 2006</b>  | \$ 7,712        | \$ 6,299 | \$ 27,563            | \$ (637)  |                         | \$ 40,937 |
| Comprehensive income:  |                 |          |                      |   |                         |           |
| Net income   |                 |          | 4,037                |   | \$ 4,037                | 4,037     |
| Other comprehensive income:  |                 |          |                      |   |                         |           |
| Unrealized holding gains arising during the period, net of deferred income taxes of \$90     |                 |          |                      | 174   | 174                     | 174       |
| Total comprehensive income   |                 |          |                      |   | \$ 4,211                |           |
| Issuance of common stock, employee benefit plan (3,635 shares)                               | 9               | 91       |                      |   |                         | 100       |
| Issuance of restricted stock, stock incentive plan (2,101 shares)                            | 5               | (5)      |                      |   |                         |           |
| Income tax benefit on vesting of restricted stock  |                 | 1        |                      |   |                         | 1         |
| Stock-based compensation expense   |                 | 191      |                      |   |                         | 191       |
| Issuance of common stock, dividend investment plan (16,517 shares)                           | 41              | 388      |                      |   |                         | 429       |
| Dividends declared (\$0.48 per share)  |                 |          | (1,493)              |   |                         | (1,493)   |
| <b>Balance, September 30, 2007</b>   | \$ 7,767        | \$ 6,965 | \$ 30,107            | \$ (463)  |                         | \$ 44,376 |
| <b>Balance, December 31, 2007</b>  | \$ 7,798        | \$ 7,153 | \$ 30,832            | \$ (605)  |                         | \$ 45,178 |
| Comprehensive income:  |                 |          |                      |   |                         |           |
| Net income   |                 |          | 2,340                |   | \$ 2,340                | 2,340     |
| Other comprehensive income:  |                 |          |                      |   |                         |           |
| Unrealized holding losses arising during the period, net of deferred income taxes of \$1,265 |                 |          |                      | (2,455)   | (2,455)                 | (2,455)   |
| Total comprehensive income   |                 |          |                      |   | \$ (115)                |           |
| Issuance of restricted stock, stock incentive plan (3,075 shares)                            | 8               | (8)      |                      |   |                         |           |
| Income tax benefit on vesting of restricted stock  |                 | (6)      |                      |   |                         | (6)       |
| Stock-based compensation expense   |                 | 110      |                      |   |                         | 110       |
| Issuance of common stock, dividend investment plan (21,462 shares)                           | 53              | 371      |                      |   |                         | 424       |
| Dividends declared (\$0.50 per share)  |                 |          | (1,572)              |   |                         | (1,572)   |
| <b>Balance, September 30, 2008</b>   | \$ 7,859        | \$ 7,620 | \$ 31,600            | \$ (3,060)                                      |                         | \$ 44,019 |

See Notes to Consolidated Financial Statements



**Table of Contents****EAGLE FINANCIAL SERVICES, INC.****Consolidated Statements of Cash Flows (Unaudited)**

(dollars in thousands)

|  | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2008</b>                                | <b>2007</b> |
| <b>Cash Flows from Operating Activities</b>  |  |             |
| Net income   | \$ 2,340                                   | \$ 4,037    |
| Adjustments to reconcile net income to net cash provided by operating activities:          |  |             |
| Depreciation   | 604  | 571         |
| Amortization of intangible and other assets  | 105  | 176         |
| Loss on equity investment  |  | 6           |
| Loss on securities   | 2,488                                      |             |
| Provision for loan losses  | 1,210                                      | 225         |
| (Gain) on the sale of loans  | (376)                                      |             |
| (Gain) on the sale of bank premises and equipment  | (742)                                      |             |
| Loss on the sale of other real estate owned  | 70   |             |
| Accrual of restricted stock awards   |  | 191         |
| Premium amortization (discount accretion) on securities, net                               | (15)                                       | 13          |
| Changes in assets and liabilities:   |  |             |
| Decrease in other assets   | 81   | 55          |
| Increase (decrease) in other liabilities   | (172)                                      | 35          |
| Net cash provided by operating activities  | \$ 5,593                                   | \$ 5,309    |
| <b>Cash Flows from Investing Activities</b>  |  |             |
| Proceeds from maturities and principal payments of securities held to maturity             | \$   | \$ 788      |
| Proceeds from maturities and principal payments of securities available for sale           | 19,892                                     | 14,924      |
| Purchases of securities held to maturity   |  | (2,557)     |
| Purchases of securities available for sale   | (36,727)                                   | (8,374)     |
| Proceeds from the sale of bank premises and equipment                                      | 1,395                                      |             |
| Purchases of bank premises and equipment   | (293)                                      | (1,839)     |
| Proceeds from the sale of loans  | 2,783                                      |             |
| Proceeds from the sale of other real estate owned  | 145  |             |
| Net increase in loans  | (5,430)                                    | (1,284)     |
| Net cash provided by (used in) investing activities  | \$ (18,235)                                | \$ 1,658    |
| <b>Cash Flows from Financing Activities</b>  |  |             |
| Net decrease in demand deposits, money market and savings accounts                         | \$ (273)                                   | \$ (8,807)  |
| Net decrease in certificates of deposit  | (12,286)                                   | (2,147)     |
| Net increase in federal funds purchased and securities sold under agreements to repurchase | 6,379                                      | 637         |
| Net increase in Federal Home Loan Bank advances  | 15,000                                     |             |
| Issuance of common stock, employee benefit plan  |  | 100         |
| Cash dividends paid  | (1,148)                                    | (1,064)     |
| Net cash provided by (used in ) financing activities                                       | \$ 7,672                                   | \$ (11,281) |

(continued)



**Table of Contents****EAGLE FINANCIAL SERVICES, INC.****Consolidated Statements of Cash Flows (Unaudited)**

(continued)

(dollars in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                | <b>2007</b> |
| (Decrease) in cash and cash equivalents                                     | \$ (4,970)                                 | \$ (4,314)  |
| <b>Cash and Cash Equivalents</b>  |  |             |
| Beginning   | 13,568                                     | 15,962      |
| Ending  | \$ 8,598                                   | \$ 11,648   |
| <b>Supplemental Disclosures of Cash Flow Information</b>                    |  |             |
| Cash payments for:  |  |             |
| Interest  | \$ 8,197                                   | \$ 10,471   |
| Income taxes  | \$ 2,150                                   | \$ 1,555    |
| <b>Supplemental Schedule of Noncash Investing and Financing Activities:</b> |  |             |
| Unrealized gain (loss) on securities available for sale                     | \$ (3,720)                                 | \$ 264      |
| Other real estate acquired in settlement of loans                           | \$ 805                                     | \$ 215      |
| Issuance of common stock, dividend investment plan                          | \$ 425                                     | \$ 429      |
| See Notes to Consolidated Financial Statements                              |  |             |

**Table of Contents****EAGLE FINANCIAL SERVICES, INC.****Notes to Consolidated Financial Statements (Unaudited)****September 30, 2008****NOTE 1. General**

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

In the opinion of management, the accompanying financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position at September 30, 2008 and December 31, 2007, the results of operations for the three and nine months ended September 30, 2008 and 2007 and cash flows for the nine months ended September 30, 2008 and 2007. The results of operations for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year. These financial statements should be read in conjunction with the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007 (the 2007 Form 10-K).

The Company owns 100% of Bank of Clarke County (the Bank) and Eagle Financial Statutory Trust II. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions between the Company and the Bank have been eliminated. Eagle Financial Statutory Trust II is accounted for under the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46R. The subordinated debt of Eagle Financial Statutory Trust II is reflected as a liability of the Company.

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

**NOTE 2. Stock-Based Compensation Plan**

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

The Company periodically grants restricted stock to its directors and executive officers. Restricted Stock provides grantees with rights to shares of common stock upon completion of a service period or achievement of Company performance measures. During the restriction period, all shares are considered outstanding and dividends are paid to the grantee. In general, outside directors are periodically granted restricted shares which vest over a period of less than six months. Beginning during 2006, 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 Company recognizes compensation expense over the restriction period. Compensation expense was \$55,000 and \$123,000 during the nine months ended September 30, 2008 and 2007, respectively. The following table presents restricted stock activity for the nine months ended September 30, 2008 and 2007:

|                                | Nine Months Ended September 30,<br>2008 |   | 2007    |   |
|--------------------------------|---|---|---------|---|
|                                | Shares                                  | Weighted<br>Average<br>Grant Date<br>Fair Value | Shares  | Weighted<br>Average<br>Grant Date<br>Fair Value |
| Nonvested, beginning of period | 11,770                                  | \$ 29.06  | 9,330   | \$ 26.47  |
| Granted                        | 10,830                                  | 22.14   | 10,830  | 29.30   |
| Vested                         | (3,075)                                 | 28.92   | (2,101) | 27.75   |
| Forfeited                      | (4,033)                                 | 27.13   | (369)   | 27.75   |

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

|                          |        |    |       |        |    |       |
|--------------------------|--------|----|-------|--------|----|-------|
| Nonvested, end of period | 15,492 | \$ | 24.75 | 17,690 | \$ | 28.02 |
|--------------------------|--------|----|-------|--------|----|-------|

**Table of Contents****NOTE 3. Earnings Per Common Share**

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

The following table shows the weighted average number of shares used in computing earnings per share for the three and nine months ended September 30, 2008 and 2007 and the effect on the weighted average number of shares of dilutive potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2008                                | 2007      | 2008                               | 2007      |
| Average number of common shares outstanding  | 3,139,734                           | 3,103,924 | 3,132,495                          | 3,097,225 |
| Effect of dilutive common stock  | 8,548                               | 9,891     | 7,137                              | 12,144    |
| Average number of common shares outstanding used to calculate diluted earnings per share | 3,148,282                           | 3,113,815 | 3,139,632                          | 3,109,369 |

**NOTE 4. Securities**

Amortized costs and fair values of securities available for sale at September 30, 2008 and December 31, 2007 were as follows:

|  | Amortized<br>Cost                    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value |
|--|--------------------------------------|------------------------------|---------------------------------|---------------|
|  | September 30, 2008<br>(in thousands) |                              |                                 |               |
| Obligations of U.S. government corporations and agencies | \$ 24,064                            | \$ 235                       | \$ (127)                        | \$ 24,172     |
| Mortgage-backed securities                               | 21,186                               | 122                          | (74)                            | 21,234        |
| Obligations of states and political subdivisions         | 30,145                               | 177                          | (158)                           | 30,164        |
| Corporate securities                                     | 15,796                               | 12                           | (2,746)                         | 13,062        |
| Equity securities  | 2,555                                |                              | (982)                           | 1,573         |
| Restricted stock   | 4,674                                |                              |                                 | 4,674         |
|  | \$ 98,420                            | \$ 546                       | \$ (4,087)                      | \$ 94,879     |
|  | December 31, 2007<br>(in thousands)  |                              |                                 |               |
| Obligations of U.S. government corporations and agencies | \$ 27,647                            | \$ 335                       | \$ (18)                         | \$ 27,964     |
| Mortgage-backed securities                               | 16,138                               | 89                           | (115)                           | 16,112        |
| Obligations of states and political subdivisions         | 2,799                                | 20                           | (8)                             | 2,811         |
| Corporate securities                                     | 3,945                                | 34                           | (159)                           | 3,820         |
| Restricted securities                                    | 4,010                                |                              |                                 | 4,010         |
|  | \$ 54,539                            | \$ 478                       | \$ (300)                        | \$ 54,717     |

There were no sales of securities available for sale during the first nine months of 2007 and 2008.

## Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

During March 2008, the Company's Board of Directors approved changing the designation of all securities to available for sale. In accordance with generally accepted accounting principles, the Company is prohibited from designating any securities as held to maturity for the foreseeable future. Securities with a total amortized cost of \$28,818,000 and a total fair value of \$28,939,000 were transferred from held to maturity to available for sale, which resulted in an unrealized gain of \$121,000. The resulting net unrealized gain of \$80,000 was included in other comprehensive income.

**Table of Contents**

The fair value and gross unrealized losses for securities available for sale, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at September 30, 2008 and December 31, 2007 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 |
|  | <b>September 30, 2008</b><br>(in thousands) |                         |                   |                         |            |                         |
| Obligations of U.S. government corporations and agencies | 7,872                                       | 127                     |                   |                         | 7,872      | 127                     |
| Mortgage-backed securities                               | 7,599                                       | 74                      |                   |                         | 7,599      | 74                      |
| Obligations of states and political subdivisions         | 9,142                                       | 136                     | 368               | 22                      | 9,510      | 158                     |
| Corporate securities                                     | 10,961                                      | 2,521                   | 1,262             | 225                     | 12,223     | 2,746                   |
| Equity securities  | 1,573                                       | 982                     |                   |                         | 1,573      | 982                     |
|  | \$ 37,147                                   | \$ 3,840                | \$ 1,630          | \$ 247                  | \$ 38,777  | \$ 4,087                |
|  | <b>December 31, 2007</b><br>(in thousands)  |                         |                   |                         |            |                         |
| Obligations of U.S. government corporations and agencies | \$  | \$                      | \$ 10,591         | \$ 18                   | \$ 10,591  | \$ 18                   |
| Mortgage-backed securities                               |   |                         | 8,714             | 115                     | 8,714      | 115                     |
| Obligations of states and political subdivisions         | 202   | 4                       | 381               | 4                       | 583        | 8                       |
| Corporate securities                                     | 1,823                                       | 159                     |                   |                         | 1,823      | 159                     |
|  | \$ 2,025                                    | \$ 163                  | \$ 19,686         | \$ 137                  | \$ 21,711  | \$ 300                  |

Gross unrealized losses on available for sale securities included seventy-nine (79) and thirty-eight (38) debt securities at September 30, 2008 and December 31, 2007, 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 on obligations of U.S. government corporations and agencies, mortgage-backed securities, and obligations of states and political subdivisions at September 30, 2008 and December 31, 2007 was changes in market interest rates. Since these losses can be 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 Company's holdings of corporate securities and equity securities represent investments in larger financial institutions. The current economic crisis involving housing, liquidity and credit were the primary causes of the unrealized losses on these securities at September 30, 2008. The Company monitors the financial condition of these issuers continuously and will record other-than-temporary impairment if the recovery of value is unlikely.

As a result of the Federal Housing Finance Agency's (FHFA) conservatorship of Fannie Mae and Freddie Mac, the Company recorded an impairment charge of \$2,488,000 on September 30, 2008 related to its holdings of preferred stock issued by these entities.



**Table of Contents**

Amortized costs and fair values of securities held to maturity at December 31, 2007 were as follows:

|  | Amortized<br>Cost                   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair<br>Value |
|--|-------------------------------------|------------------------------|---------------------------------|---------------|
|  | December 31, 2007<br>(in thousands) |                              |                                 |               |
| Mortgage-backed securities                       | \$ 282                              | \$                           | \$ (4)                          | \$ 278        |
| Obligations of states and political subdivisions | 29,238                              | 51                           | (176)                           | 29,113        |
|  | \$ 29,520                           | \$ 51                        | \$ (180)                        | \$ 29,391     |

The fair value and gross unrealized losses for securities held to maturity, totaled by the length of time that individual securities have been in a continuous gross unrealized loss position, at December 31, 2007 were as follows:

|  | Less than 12 months                 |                               | 12 months or more |                               | Total      |                               |
|--|-------------------------------------|-------------------------------|-------------------|-------------------------------|------------|-------------------------------|
|  | Fair Value                          | Gross<br>Unrealized<br>Losses | Fair Value        | Gross<br>Unrealized<br>Losses | Fair Value | Gross<br>Unrealized<br>Losses |
|  | December 31, 2007<br>(in thousands) |                               |                   |                               |            |                               |
| Mortgage-backed securities                       | \$                                  | \$                            | \$ 278            | \$ 4                          | \$ 278     | \$ 4                          |
| Obligations of states and political subdivisions | 3,465                               | 29                            | 16,379            | 147                           | 19,844     | 176                           |
|  | \$ 3,465                            | \$ 29                         | \$ 16,657         | \$ 151                        | \$ 20,122  | \$ 180                        |

Gross unrealized losses on held to maturity securities included sixty-four (64) debt securities at December 31, 2007. The Company evaluates its available for sale securities for other than temporary impairment on at least a quarterly basis, and more frequently when economic or market conditions warrant such an 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 a security long enough to allow for an anticipated recovery in its 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, 2007 was changes in market interest rates.

**Table of Contents****NOTE 5. Loans**

The composition of loans at September 30, 2008 and December 31, 2007 was as follows:

|  | September 30,<br>2008 | December 31,<br>2007 |
|--|-----------------------|----------------------|
|  | (in thousands)        |                      |
| Mortgage loans on real estate:               |                       |                      |
| Construction and land development            | \$ 34,716             | \$ 33,268            |
| Secured by farmland                          | 5,465                 | 7,468                |
| Secured by 1-4 family residential properties | 187,996               | 182,343              |
| Other real estate loans                      | 113,418               | 111,565              |
| Loans to farmers                             | 982                   | 1,039                |
| Commercial and industrial loans              | 25,746                | 27,027               |
| Consumer installment loans                   | 19,776                | 25,368               |
| All other loans                              | 3,290                 | 1,583                |
|  | \$ 391,389            | \$ 389,661           |
| Less: Allowance for loan losses              | 3,911                 | 3,191                |
|  | \$ 387,478            | \$ 386,470           |

**NOTE 6. Allowance for Loan Losses**

Changes in the allowance for loan losses for the nine months ended September 30, 2008 and 2007 and the year ended December 31, 2007 were as follows:

|  | Nine Months Ended<br>September 30,<br>2008 | Year Ended<br>December 31, 2007<br>(in thousands) | Nine Months Ended<br>September 30,<br>2007 |
|--|--|---|--|
| Balance, beginning                     | \$ 3,191                                   | \$ 3,308  | \$ 3,308                                   |
| Provision charged to operating expense | 1,210                                      | 550   | 225  |
| Recoveries added to the allowance      | 66   | 138   | 114  |
| Loan losses charged to the allowance   | (556)                                      | (805)   | (405)                                      |
| Balance, ending                        | \$ 3,911                                   | \$ 3,191  | \$ 3,242                                   |

Total loans past due ninety days or greater still accruing interest were \$687,000 and \$813,000 at September 30, 2008 and December 31, 2007, respectively. Total nonaccrual loans were \$3,160,000 at September 30, 2008. If interest would have been accrued on these loans, such income would have been \$72,000 during 2008. All of the nonaccrual loans were impaired and there were no additional impaired loans at September 30, 2008. There were no nonaccrual or impaired loans at December 31, 2007.

**NOTE 7. Deposits**

The composition of deposits at September 30, 2008 and December 31, 2007 was as follows:

| September 30,<br>2008 | December 31,<br>2007 |
|-----------------------|----------------------|
|-----------------------|----------------------|

Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

|   | (in thousands) |            |
|---|----------------|------------|
| Noninterest bearing demand deposits           | \$ 85,083      | \$ 81,763  |
| Savings and interest bearing demand deposits: |                |            |
| NOW accounts                                  | \$ 56,965      | \$ 69,635  |
| Money market accounts                         | 52,533         | 43,747     |
| Regular savings accounts                      | 33,675         | 33,384     |
|   | \$ 143,173     | \$ 146,766 |
| Time deposits:                                |                |            |
| Balances of less than \$100,000               | \$ 77,753      | \$ 73,681  |
| Balances of \$100,000 and more                | 61,017         | 77,375     |
|   | \$ 138,770     | \$ 151,056 |
|   | \$ 367,026     | \$ 379,585 |

**Table of Contents****NOTE 8. Pension and Postretirement Benefit Plans**

The Company has a funded noncontributory defined benefit pension plan that covers substantially all of its employees. The plan provides defined benefits based on years of service and final average salary. Effective December 31, 2006, the pension plan was amended so that no further benefits will accrue under the plan and no additional employees may become participants.

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

On December 31, 2006, the Company adopted FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*—an amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS No. 158). SFAS No. 158 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 pension and postretirement benefit plans in the consolidated balance sheet, with a corresponding adjustment to accumulated other comprehensive income, net of taxes.

The following tables provide the components of net periodic benefit cost of the pension plan and postretirement benefit plan for the three and nine months ended September 30, 2008 and 2007:

|   | Pension Benefits                      |                                       | Postretirement Benefits               |                                       |
|---|---------------------------------------|---------------------------------------|---------------------------------------|---------------------------------------|
|   | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 | Three Months Ended September 30, 2008 | Three Months Ended September 30, 2007 |
| (in thousands)                                  |                                       |                                       |                                       |                                       |
| <b>Components of Net Periodic Benefit Cost:</b> |                                       |                                       |                                       |                                       |
| Service cost                                    | \$                                    | \$                                    | \$                                    | \$                                    |
| Interest cost                                   | 45                                    | 49                                    | 4                                     | 5                                     |
| Expected return on plan assets                  | (42)                                  | (44)                                  |                                       |                                       |
| Amortization of prior service costs             |                                       |                                       |                                       |                                       |
| Amortization of transition obligation           |                                       |                                       | 1                                     | 1                                     |
| Amortization of net actuarial loss              | 41                                    | 46                                    |                                       | 2                                     |
| Net periodic benefit cost                       | \$ 44                                 | \$ 51                                 | \$ 5                                  | \$ 8                                  |

|   | Pension Benefits                     |                                      | Postretirement Benefits              |                                      |
|---|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
|   | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 | Nine Months Ended September 30, 2008 | Nine Months Ended September 30, 2007 |
| (in thousands)                                  |                                      |                                      |                                      |                                      |
| <b>Components of Net Periodic Benefit Cost:</b> |                                      |                                      |                                      |                                      |
| Service cost                                    | \$                                   | \$                                   | \$                                   | \$                                   |
| Interest cost                                   | 135                                  | 147                                  | 12                                   | 15                                   |
| Expected return on plan assets                  | (126)                                | (132)                                |                                      |                                      |
| Amortization of prior service costs             |                                      |                                      |                                      |                                      |
| Amortization of transition obligation           |                                      |                                      | 1                                    | 3                                    |
| Amortization of net actuarial loss              | 123                                  | 138                                  |                                      | 6                                    |
| Net periodic benefit cost                       | \$ 132                               | \$ 153                               | \$ 13                                | \$ 24                                |

Note 9 to the consolidated financial statements in the 2007 Form 10-K stated that the Company did not anticipate making any contributions to its pension during 2008. The Company did not make any contributions during the first nine months of 2008.



---

**Table of Contents**

**NOTE 9. Trust Preferred Capital Notes**

In June 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 June 20, 2007, Trust II issued \$7,000,000 of trust preferred securities and \$217,000 in common equity. The principal asset of Trust II is \$7,217,000 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 September 30, 2008 was 4.43%. The securities have a mandatory redemption date of September 1, 2037, and are 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 September 30, 2008, the total amount (\$7,000,000) of trust preferred securities issued by Trust II are included in the Company's Tier 1 capital.

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

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

**NOTE 10. Fair Value Measurements**

FASB Statement No. 157, Fair Value Measurements (SFAS No. 157), 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:** 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. Currently, all of the Company's securities are considered to be Level 2 securities.

**Impaired Loans:** SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS No. 114,

Accounting by Creditors for Impairment of a Loan, including impaired loans measured at an observable market price (if available), or at the fair value of the loan's collateral (if the loan is collateral dependent). Fair value of the loan's collateral, when the loan is dependent on collateral, is determined by appraisals or independent valuation which is then adjusted for the cost related to liquidation of the collateral.

**Other Real Estate Owned:** Certain assets such as other real estate owned (OREO) are measured at fair value less cost to sell. We believe that the fair value component in its valuation follows the provisions of SFAS No. 157.



---

**Table of Contents**

**NOTE 11. Recent Accounting Pronouncements**

In December 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 141(R), Business Combinations ( SFAS No. 141(R) ). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS No. 141(R) establishes the criteria for how an acquiring entity in a business combination recognizes the assets acquired and liabilities assumed in the transaction; establishes the acquisition date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. Acquisition related costs including finder s fees, advisory, legal, accounting valuation and other professional and consulting fees are required to be expensed as incurred. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008 and early implementation is not permitted. The Company does not expect the implementation to have a material impact on its financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No.160, Noncontrolling Interests in Consolidated Financial Statements ( SFAS No. 160 ). SFAS No. 160 requires the Company to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company does not expect the implementation of SFAS No. 160 to have a material impact on its financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( SFAS No. 161 ). SFAS No. 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with early application permitted. The Company does not expect the implementation of SFAS No. 161 to have a material impact on its financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, The Hierarchy of Generally Accepted Accounting Principles ( SFAS No. 162 ). This Statement identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS 162 becomes effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411. The Company does not expect the implementation of SFAS No. 162 to have a material impact on its financial statements.

In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 ( FSP No. 157-2 ). FSP No. 157-2 delays the effective date of SFAS 157, Fair Value Measurements, for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. FSP No. 157-2 defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for items within the scope of this FSP. Examples of items to which the deferral would and would not apply are listed in FSP No. 157-2. The Company does not expect the implementation of FSP No. 157-2 to have a material impact on its financial statements.

In October 2008, the FASB issued FASB Staff Position No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active ( FSP No. 157-3 ). FSP No. 157-3 clarifies the application of SFAS 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP No. 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued.



## **Table of Contents**

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

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

Form 10-Q and Item 8, Financial Statements and Supplementary Data, of the 2007 Form 10-K.

#### GENERAL

Eagle Financial Services, Inc. is a bank holding company which owns 100% of the stock of Bank of Clarke County (the Bank), collectively (the Company). Accordingly, the results of operations for the Company are dependent upon the operations of the Bank. The Bank conducts commercial banking business which consists of attracting deposits from the general public and investing those funds in commercial, consumer and real estate loans and corporate, municipal and U.S. government agency securities. The Bank's deposits are insured by the Federal Deposit Insurance Corporation to the extent permitted by law. At September 30, 2008, the Company had total assets of \$515,031,000, net loans of \$387,478,000, total deposits of \$367,026,000 and shareholders' equity of \$44,019,000. The Company's net income (loss) was \$(1,430,000) for the three months ended September 30, 2008 and \$2,340,000 for the nine months ended September 30, 2008.

#### MANAGEMENT'S STRATEGY

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

#### OPERATING STRATEGY

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

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

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

#### LENDING POLICIES

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

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

policies.

## **Table of Contents**

The Bank uses a Directors Loan Committee and lending limits approved by the Directors Loan Committee to approve loan requests. The loan officers are categorized based on the amount of secured and unsecured lending authority they possess. The highest authority (Category I) is comprised of the Bank's Chief Executive Officer and the Senior Loan Officer. There are six additional categories (Categories II, III, IV, V, VI, and VII) with different amounts of secured and unsecured authority. Two officers in Category I may combine their authority to approve a loan request of up to \$2,000,000 secured or \$1,000,000 unsecured. An officer in Category II, III, IV, V, VI, or VII may combine his or her authority with one officer in a higher category to approve a loan request. Any loan request which exceeds the combined authority of the categories must be presented to the Directors Loan Committee. The Directors Loan Committee, which currently consists of four directors (three directors constitute a quorum, of whom any two may act), approves loan requests which exceed the combined authority of two loan officers as described above. The minimum amount which requires Director Loan Committee approval, which is derived by combining the authorities of a Category I and Category VII officer, is \$1,025,000 secured and \$505,000 unsecured. The Directors 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 borrower's 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.

## **Table of Contents**

### *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. The allowance for loan losses is based on two accounting principles: (1) Statement of Financial Accounting Standards (SFAS) No. 5, "Accounting for Contingencies", which requires that losses be accrued when their occurrence is probable and they can be estimated, and (2) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan", which requires that losses be accrued based on the differences between the loan balance and the value of its collateral, the present value of future cash flows, or the price established in the secondary market. The Company's allowance for loan losses has three basic components: the formula 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 formula allowance uses historical experience factors to estimate future losses and, as a result, the estimated amount of losses can differ significantly from the actual amount of losses which would be incurred in the future. However, the potential for significant differences is mitigated by continuously updating the loss history of the Company. The specific allowance is based upon the evaluation of specific loans on which a loss may be realized. Factors such as past due history, ability to pay, and collateral value are used to identify those loans on which a loss may be realized. Each of these loans is then classified as to how much loss would be realized on its disposition. The sum of the losses on the individual loans becomes the Company's specific allowance. This process is inherently subjective and actual losses may be greater than or less than the estimated specific allowance. The unallocated allowance captures losses that are attributable to various economic events which may affect a certain loan type within the loan portfolio or a certain industrial or geographic sector within the Company's market. As the loans, which are affected by these events, are identified or losses are experienced on the loans which are affected by these events, they will be reflected within the specific or formula allowances. Note 1 to the Consolidated Financial Statements presented in Item 8, Financial Statements and Supplementary Data, of the 2007 Form 10-K, provides additional information related to the allowance for loan losses.

**Table of Contents**

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, words or terms are intended to identify forward looking statements. These forward looking statements are subject to significant uncertainties because they are based upon or are affected by factors including:

the ability to successfully manage growth or implement growth strategies if the Bank is unable to identify attractive markets, locations or opportunities to expand in the future;

competition with other banks and financial institutions, and companies outside of the banking industry, including those companies that have substantially greater access to capital and other resources;

the successful management of interest rate risk;

risks inherent in making loans such as repayment risks and fluctuating collateral values;

changes in general economic and business conditions in the market area;

reliance on the management team, including the ability to attract and retain key personnel;

changes in interest rates and interest rate policies;

maintaining capital levels adequate to support growth;

maintaining cost controls and asset qualities as new branches are opened or acquired;

demand, development and acceptance of new products and services;

problems with technology utilized by the Bank;

changing trends in customer profiles and behavior;

changes in banking and other laws and regulations; and

## Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

other factors described in Item 1A., Risk Factors, in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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.

**Table of Contents****RESULTS OF OPERATIONS***Net Income*

Net income for the first nine months of 2008 was \$2,340,000, an decrease of \$1,697,000 or 42.04% as compared to net income for the first nine months of 2007 of \$4,037,000. Earnings per share, basic and diluted, were \$0.75 and \$1.30 for the first nine months of 2008 and 2007, respectively. The net loss for the third quarter of 2008 was \$1,430,000, a decrease of \$2,723,000 or 210.6% as compared to net income for the third quarter of 2007 of \$1,293,000. Earnings per share, basic and diluted, were \$(0.45) and \$0.42 for the third quarter of 2008 and 2007, respectively.

Return on average assets (ROA) measures how efficiently the Company uses its assets to produce net income. Some issues reflected within this efficiency include the Company's asset mix, funding sources, pricing, fee generation, and cost control. The ROA of the Company, on an annualized basis, for the first nine months of 2008 and 2007 was 0.72% and 1.07%, respectively.

Return on average equity (ROE) measures the utilization of shareholders' equity in generating net income. This measurement is affected by the same factors as ROA with consideration to how much of the Company's assets are funded by shareholders. The ROE of the Company, on an annualized basis, for the first nine months of 2008 and 2007 was 8.03% and 12.70%, 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 \$14,197,000 and \$12,848,000 for the first nine months of 2008 and 2007, respectively, which represents an increase of \$1,349,000 or 10.5%. Net interest income was \$4,799,000 and \$4,374,000 for the third quarter of 2008 and 2007, respectively, which represents an increase of \$425,000 or 9.7%. The amount of net interest income is derived from the volume of earning assets and the rates earned on those assets as compared to the cost of funds. Total interest income was \$22,295,000 and \$23,373,000 for the first nine months of 2008 and 2007, respectively, which represents a decrease of \$1,078,000 or 4.6%. Total interest income was \$7,298,000 and \$7,879,000 for the third quarter of 2008 and 2007, respectively, which represents a decrease of \$581,000 or 7.4%. Total interest expense was \$8,098,000 and \$10,525,000 for the first nine months of 2008 and 2007, respectively, which represents a decrease of \$2,427,000 or 23.1%. Total interest expense was \$2,499,000 and \$3,505,000 for the third quarter of 2008 and 2007, respectively, which represents a decrease of \$1,006,000 or 28.7%.

The net interest margin was 4.03% and 3.74% for the first nine months of 2008 and 2007, respectively. The increase of 29 basis points in the net interest margin was due to a greater decrease in the average rate on interest-bearing liabilities than the tax-equivalent yield on average earning assets. 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 2008 and 2007. The following table reconciles tax-equivalent net interest income, which is not a measurement under accounting principles generally accepted in the United States of America (GAAP), to net interest income.

|   | Three Months Ended<br>September 30,<br>2008      2007 |                 | Nine Months Ended<br>September 30,<br>2008      2007 |                  |
|---|---|-----------------|--|------------------|
|   | (in thousands)  |                 |  |                  |
| <b>GAAP Financial Measurements:</b>                             |   |                 |  |                  |
| Interest Income - Loans   | \$ 6,133  | \$ 6,882        | \$ 18,818  | \$ 20,404        |
| Interest Income - Securities and Other Interest-Earnings Assets | 1,165   | 997             | 3,477  | 2,969            |
| Interest Expense - Deposits                                     | 1,618   | 2,682           | 5,427  | 8,194            |
| Interest Expense - Other Borrowings                             | 881   | 823             | 2,671  | 2,331            |
| <b>Total Net Interest Income</b>                                | <b>\$ 4,799</b>                                       | <b>\$ 4,374</b> | <b>\$ 14,197</b>                                     | <b>\$ 12,848</b> |
| <b>Non-GAAP Financial Measurements:</b>                         |   |                 |  |                  |
| Add: Tax Benefit on Tax-Exempt Interest Income - Loans          | \$ 33   | \$ 19           | \$ 79  | \$ 57            |
| Add: Tax Benefit on Tax-Exempt Interest Income - Securities     | 146   | 155             | 449  | 445              |



Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

|  |          |          |           |           |
|--|----------|----------|-----------|-----------|
| <b>Total Tax Benefit on Tax-Exempt Interest Income</b> | \$ 179   | \$ 174   | \$ 528    | \$ 502    |
| <b>Tax-Equivalent Net Interest Income</b>              | \$ 4,978 | \$ 4,548 | \$ 14,725 | \$ 13,350 |

## Table of Contents

The tax-equivalent yield on earning assets decreased 44 basis points from 6.68% to 6.24% for the first nine months of 2007 and 2008, respectively. The tax-equivalent yield on securities increased 45 basis points from 4.97% to 5.42% for the first nine months of 2007 and 2008, respectively. The tax-equivalent yield on loans decreased 62 basis points from 7.09% to 6.47% for the first nine months of 2007 and 2008, respectively. The average rate on interest bearing liabilities decreased 91 basis points from 3.71% to 2.80% for the first nine months of 2007 and 2008, respectively. These changes were caused primarily by deposit pricing and product mix. The average rate on interest bearing deposits decreased 103 basis points from 3.52% to 2.49% for the first nine months of 2007 and 2008. In general, deposit pricing is done in response to monetary policy actions and yield curve changes. Also, local competition for funds affects the cost of time deposits, which are primarily comprised of certificates of deposit. The Company prefers to rely more heavily on non-maturity deposits, which include NOW accounts, money market accounts, and savings accounts. Changes in the average rate on interest-bearing liabilities can also be affected by the pricing on other sources of funds, namely borrowings. The Company utilized overnight borrowings in the form of federal funds purchased, retail repurchase agreements and wholesale repurchase agreements. The average rate on these borrowings decreased 79 basis points from 3.68% to 2.90% for the first nine months of 2007 and 2008. The cost of federal funds purchased is affected by the Federal Reserve's changes in the federal funds target rate, which was decreased from 4.25% to 2.00% during the first nine months of 2008. The rate on retail repurchase agreements is variable and changes monthly. The Company also borrows from the FHLB in the form of short and long term advances. The average rate on FHLB advances decreased 41 basis points from 4.23% to 3.82% for the first nine months of 2007 and 2008.

### *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 \$710,000 and \$75,000 for the three months ended September 30, 2008 and 2007, respectively. The provision for loan losses was \$1,210,000 and \$225,000 for the first nine months of 2008 and 2007, respectively. The amount of provision for loan losses is affected by several factors including the growth rate of loans, net charge-offs, the amount of potential losses within the loan portfolio and prevailing economic conditions. The increase during 2008 as compared to 2007 reflects the negative direction of the overall economy, which generally increases the potential losses within the loan portfolio.

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. This analysis identifies changes in the creditworthiness of specific borrowers and changes in the value of collateral securing certain loans. The results, which consider net charge-offs and the provision, indicate whether the Company's allowance for loan losses is adequate given the potential losses within the loan portfolio. This analysis indicated that the Company's allowance for loan losses was adequate at September 30, 2008.

### *Noninterest Income*

Total noninterest income for the first nine months of 2008 and 2007 was \$3,356,000 and \$4,664,000, respectively, which represents a decrease of \$1,308,000 or 28.0%. Total noninterest income for the third quarter of 2008 and 2007 was \$(1,035,000) and \$1,617,000, respectively, which represents a decrease of \$2,652,000 or 164.0%. The decreases can be attributed to the loss on securities, which reflects the impairment charge that is discussed in Note 4 above. Excluding the loss on securities, total noninterest income was \$1,453,000 for the quarter, which represents a decrease of \$164,000, and \$5,844,000 for the first nine months of 2008, which represents an increase of \$1,180,000. Management reviews the activities which generate noninterest income on an ongoing basis. The following paragraphs provide information about activities which are included within the respective Consolidated Statements of Income headings.

There were no sales or calls of securities which resulted in a gain or loss during the first nine months of 2008 and 2007.

Income from fiduciary activities, generated by trust services offered through Eagle Investment Group, decreased \$4,000 or 0.6% from \$704,000 for the first nine months of 2007 to \$700,000 for the first nine months of 2008. Income from fiduciary activities decreased \$8,000 or 3.7% from \$215,000 for the third quarter of 2007 to \$207,000 for the third quarter of 2008. 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.

Service charges on deposit accounts increased \$104,000 or 6.3% from \$1,662,000 to \$1,766,000 for the first nine months of 2007 and 2008, respectively. Service charges on deposit accounts increased \$50,000 or 8.6% from \$579,000 to \$629,000 for the third quarter of 2007 and 2008, respectively. The amount of service charges on deposit accounts is derived from the volume of demand and savings accounts generated through the Bank's branch network and the Bank continues to see an increase in these account types. Management expects continued growth in the number of deposit accounts and, therefore, expects the amount of service charges on deposit accounts to increase proportionately during future periods.

## Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

Other service charges and fees increased \$45,000 or 2.2% from \$2,047,000 for the first nine months of 2007 to \$2,092,000 for the first nine months of 2008. Other service charges and fees decreased \$115,000 or 14.8% from \$779,000 for the third quarter of 2007 to \$664,000 for the third quarter of 2008. The amount of other services charges and fees is comprised primarily of commission 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. Commissions from the sale of non-deposit investment products through Eagle Investment Group decreased \$55,000 from \$709,000 to \$654,000 for the first nine months of 2007 and 2008, respectively. The amount of fees generated from the Bank's ATM/debit card programs increased \$121,000 or 20.3% from \$595,000 to \$716,000 for the first nine months of 2007 and 2008, respectively.

**Table of Contents**

The gain on the sale of loans in the amount of \$376,000 was generated from the credit card portfolio.

The gain on the sale of bank premises and equipment in the amount of \$742,000 was generated from the former Old Post Office branch building in downtown Winchester.

Other operating income decreased \$13,000 or 5.2% from \$251,000 to \$238,000 for the first nine months of 2007 and 2008, respectively. Other operating income decreased \$21,000 from \$44,000 to \$23,000 for the third quarter of 2007 and 2008, respectively.

*Noninterest Expenses*

Total noninterest expenses increased \$445,000 or 3.8% from \$11,624,000 to \$12,069,000 for the first nine months of 2007 and 2008, respectively. Total noninterest expenses increased \$20,000 or 0.5% from \$4,101,000 to \$4,121,000 for the third quarter of 2007 and 2008, respectively. The efficiency ratio of the Company was 61.79% for the nine months ended September 30, 2008 and 64.53% for the nine months ended September 30, 2007. The efficiency ratio is calculated by dividing total noninterest expenses by the sum of tax-equivalent net interest income and total noninterest income, excluding securities 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. It is management's objective to maintain an efficiency ratio at or below 65.00% for the Company. The following paragraphs provide information about expenses which are included within the respective Consolidated Statements of Income headings.

Salaries and benefits increased \$145,000 or 2.1% from \$6,802,000 for the first nine months of 2007 to \$6,947,000 for the first nine months of 2008. Salaries and benefits increased \$5,000 or 0.2% from \$2,324,000 for the third quarter of 2007 to \$2,329,000 for the third quarter of 2008. Occupancy expenses increased \$47,000 or 5.5% from \$854,000 to \$901,000 for the first nine months of 2007 and 2008, respectively. Occupancy expenses during the third quarter of 2007 and 2008 were \$294,000 and \$256,000, respectively. Equipment expenses decreased \$50,000 or 8.8% from \$569,000 to \$519,000 for the first nine months of 2007 and 2008, respectively. Equipment expenses decreased \$24,000 or 12.2% from \$197,000 to \$173,000 for the third of 2007 and 2008, respectively.

Advertising and marketing expenses decreased \$46,000 or 13.7% from \$337,000 to \$291,000 for the first nine months of 2007 and 2008, respectively. Advertising and marketing expenses decreased \$20,000 or 15.0% from \$133,000 to \$113,000 for the third quarter of 2007 and 2008, respectively. This category contains numerous expense types such as advertising, public relations, business development and charitable contributions. The total amount of advertising and marketing expenses varies from quarter to quarter based on planned events and advertising campaigns. Expenses are allocated in a manner which focuses on effectively reaching the existing and potential customers within the market and contributing to the community.

Other operating expenses increased \$339,000 or 13.6% from \$2,487,000 to \$2,826,000 for the first nine months of 2007 and 2008, respectively. Other operating expenses increased \$159,000 or 17.4% from \$914,000 to \$1,073,000 for the third quarter of 2007 and 2008, respectively. This category is primarily comprised of the cost for services required during normal operations of the Company. Expenses which are directly affected by the number of branch locations and volume of accounts at the Bank include postage, insurance, ATM network fees, and credit card processing fees. Other expenses within this category are auditing fees and computer software expenses.

*Income Taxes*

Income tax expense was \$1,934,000 and \$1,626,000 the first nine months of 2008 and 2007, respectively. The increase in income tax expense reflects increased taxable earnings at the federal statutory income tax rate of 34%. The amount of income tax expense for the first nine months of 2008 and 2007 corresponded to an effective tax rate of 45.25% and 28.71%, respectively. Normally, the difference between the effective tax rate and statutory income tax rate can be attributed to tax-exempt interest earned on certain securities and loans. This unusually high rate for first nine months of 2008 reflects the tax implications of the loss on securities, which was subject to the tax rules for capital losses. The Emergency Economic Stabilization Act of 2008 ( EESA ), which President Bush signed on October 3, 2008, includes a provision that classifies losses on agency issued preferred stocks as ordinary rather than capital for income tax purposes. As a result, a deferred tax benefit of \$0.8 million will be recognized during the fourth quarter of 2008. Had EESA been effective at September 30, 2008, the effective tax rate would have been 25.46%.

**Table of Contents**

## FINANCIAL CONDITION

*Securities*

Total securities were \$94,879,000 at September 30, 2008 as compared to \$84,237,000 at December 31, 2007. This represents an increase of \$10,642,000 or 12.6%. The Company purchased \$36,727,000 in securities during the first nine months of 2008. The Company had total maturities and principal repayments of \$19,892,000 during the first nine months of 2008. The Company did not have any securities from a single issuer, other than U.S. government agencies, whose amount exceeded 10% of shareholders' equity at September 30, 2008. Note 4 to the Consolidated Financial Statements provides additional details about the Company's securities portfolio at September 30, 2008 and December 31, 2007.

The Company had \$29,520,000 in securities classified as held to maturity at December 31, 2007. The Company had \$94,879,000 and \$54,717,000 in securities classified as available for sale at September 30, 2008 and December 31, 2007, respectively. The Company had an unrealized loss on available for sale securities of \$3,541,000 at September 30, 2008 as compared to an unrealized gain of \$178,000 at December 31, 2007. Unrealized gains or losses on available for sale securities are reported within shareholders' equity, net of the related deferred tax effect, as accumulated other comprehensive income.

*Loan Portfolio*

The Company's primary use of funds is supporting lending activities from which it derives the greatest amount of interest income. Gross loans were \$391,389,000 and \$389,661,000 at September 30, 2008 and December 31, 2007, respectively. This represents an increase of \$1,728,000 or 0.4% for the first nine months of 2008. The ratio of loans to deposits increased during the first nine months of 2008 from 102.7% at December 31, 2007 to 106.6% at September 30, 2008. The loan portfolio consists primarily of loans for owner-occupied single family dwellings, loans to acquire consumer products such as automobiles, and loans to small farms and businesses. Note 5 to the Consolidated Financial Statements provides the composition of the loan portfolio at September 30, 2008 and December 31, 2007.

Loans secured by real estate were \$341,595,000 or 87.3% and \$334,644,000 or 85.9% of total loans at September 30, 2008 and December 31, 2007, respectively. This represents an increase of \$6,951,000 or 2.1% during the first nine months of 2008. Consumer installment loans were \$19,775,000 or 5.1% and \$25,368,000 or 6.5% of total loans at September 30, 2008 and December 31, 2007, respectively. This represents a decrease of \$5,593,000 or 22.1% during the first nine months of 2008. Commercial and industrial loans were \$25,746,000 or 6.6% and \$27,027,000 or 7.0% of total loans at September 30, 2008 and December 31, 2007, respectively. This represents a decrease of \$1,281,000 or 4.7% for the first nine months of 2008.

*Allowance for Loan Losses*

The purpose of and the methods for measuring the allowance for loan losses are discussed in the Critical Accounting Policies section above. Note 6 to the Consolidated Financial Statements shows the activity within the allowance for loan losses during the nine months ended September 30, 2008 and 2007 and the year ended December 31, 2007. Charged-off loans were \$556,000 and \$405,000 for the nine months ended September 30, 2008 and 2007, respectively. Recoveries were \$66,000 and \$114,000 for the nine months ended September 30, 2008 and 2007, respectively. This resulted in net charge-offs of \$490,000 and \$291,000 for the nine months ended September 30, 2008 and 2007, respectively. Net charge-offs to average loans was 0.13% and 0.08% for the nine months ended September 30, 2008 and 2007, respectively. The allowance for loan losses as a percentage of loans was 1.00% at September 30, 2008 and 0.82% at December 31, 2007. Management believes that the allowance for loan losses is adequate based on the loan portfolio's current risk characteristics.

*Risk Elements and Nonperforming Assets*

Nonperforming assets consist of nonaccrual loans, restructured loans, and other real estate owned (foreclosed properties). The percentage of nonperforming assets to loans and other real estate owned was 1.01% and 0.06% at September 30, 2008 and December 31, 2007, respectively. There were no restructured loans at September 30, 2008 or December 31, 2007.

Nonaccrual loans were \$3,160,000 at September 30, 2008. There were no nonaccrual loans at December 31, 2007. Any loan over 90 days past due without being in the process of collection or where the collection of its principal or interest is doubtful would be placed on nonaccrual status. When a loan is placed on nonaccrual status, accrued interest is reversed from income and future accruals are discontinued with interest income being recognized on a cash basis. 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. All of the nonaccrual loans at September 30, 2008 were impaired and the allowance for loan losses includes \$1,341,000 in specific

allocations for these loans.

## Edgar Filing: EAGLE FINANCIAL SERVICES INC - Form 10-Q

Other real estate owned was \$805,000 and \$215,000 at September 30, 2008 and December 31, 2007, respectively. The amount of other real estate owned at September 30, 2008 includes three one-to-four family residential properties. The amount of other real estate owned at December 31, 2007 includes one one-to-four family residential property. The amount of other real estate owned reflects the lesser of the fair value or principal balance of each property minus the estimated selling costs of that property. If the principal balance exceeds the fair value minus selling costs, the difference is charged-off at foreclosure. 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 loss of \$70,000 was recognized on the sale of other real estate owned during 2008.

**Table of Contents**

Total loans past due 90 days or more and still accruing interest were \$687,000 or 0.18% and \$813,000 or 0.21% of total loans at September 30, 2008 and December 31, 2007, respectively. The loans past due 90 days or more and still accruing interest are secured and in the process of collection; therefore, they are not classified as nonaccrual.

Management evaluates borrowers on an ongoing basis to identify those loans on which a loss may be realized. The methods for identifying these loans and establishing estimated losses for these loans are discussed in the Critical Accounting Policies section above. Once management determines that a loan requires a specific allowance, it becomes a potential problem loan. The amount of potential problem loans was \$21,671,000 and \$25,731,000 at September 30, 2008 and December 31, 2007, respectively. This represents a decrease of \$4,060,000 or 15.8% during the first nine months of 2008. At September 30, 2008, these loans were primarily well-secured and in the process of collection, and the allowance for loan losses includes \$1,607,000 in specific allocations for these loans.

*Deposits*

Total deposits were \$367,026,000 and \$379,585,000 at September 30, 2008 and December 31, 2007, respectively. This represents a decrease of \$12,559,000 or 3.3% during the first nine months of 2008. Note 7 to the Consolidated Financial Statements provides the composition of total deposits at September 30, 2008 and December 31, 2007.

Noninterest-bearing demand deposits, which are comprised of checking accounts, increased \$3,320,000 or 4.1% from \$81,763,000 at December 31, 2007 to \$85,083,000 at September 30, 2008. Savings and interest-bearing demand deposits, which include NOW accounts, money market accounts and regular savings accounts, decreased \$3,593,000 or 2.4% from \$146,766,000 at December 31, 2007 to \$143,173,000 at September 30, 2008. Time deposits decreased \$12,286,000 or 8.1% from \$151,056,000 at December 31, 2007 to \$138,770,000 at September 30, 2008. This is comprised of a decrease in time deposits of \$100,000 and more of \$16,358,000 or 21.1% and an increase in time deposits of less than \$100,000 of \$4,072,000 or 5.5%. Certificates of deposit of less than \$100,000 also include \$15,531,000 in brokered certificates of deposit at September 30, 2008 which is an increase of \$10,000,000 or 180.8% from \$5,531,000 at December 31, 2007.

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. Core deposits totaled \$290,478,000 or 79.1% and \$296,679,000 or 78.2% of total deposits at September 30, 2008 and December 31, 2007, respectively.

**CAPITAL RESOURCES**

The Company continues to be a well capitalized financial institution. Total shareholders' equity at September 30, 2008 was \$44,018,000, reflecting a percentage of total assets of 8.56%, as compared to \$45,178,000 and 8.90% at December 31, 2007. Shareholders' equity per share decreased \$0.47 or 3.3% to \$13.93 per share at September 30, 2008 from \$14.43 per share at December 31, 2007. During the first three quarters of 2008 and 2007, the Company paid a dividend of \$0.50 and \$0.48 per share, respectively. Total dividends paid during 2007 were \$0.64 per share. The Company has a Dividend Investment Plan that reinvests the dividends of the shareholder in Company stock.

Federal regulatory risk-based capital guidelines require percentages to be applied to various assets, including off-balance sheet assets, based on their perceived risk in order to calculate risk-weighted assets. Tier 1 capital consists of total shareholders' equity plus qualifying trust preferred securities outstanding less net unrealized gains and losses on available for sale securities, goodwill and other intangible assets. Total capital is comprised of Tier 1 capital plus the allowable portion of the allowance for loan losses and any excess trust preferred securities that do not qualify as Tier 1 capital. The \$7,000,000 in trust preferred securities, issued by the Company during 2007, qualifies as Tier 1 capital because this amount does not exceed 25% of total capital, including the trust preferred securities. Financial institutions must maintain a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a minimum Tier 1 leverage ratio of 4%. The Company's policy requires a Tier 1 risk-based capital ratio of at least 8%, a total risk-based capital ratio of at least 10% and a minimum Tier 1 leverage ratio of 5%. The Company's Tier 1 risk-based capital ratio was 14.01% at September 30, 2008 as compared to 13.44% at December 31, 2007. The Company's total risk-based capital ratio was 15.02% at September 30, 2008 as compared to 14.25% at December 31, 2007. The Company's Tier 1 capital to average total assets ratio was 10.46% at September 30, 2008 and December 31, 2007. 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.



## LIQUIDITY

Liquidity management involves meeting the present and future financial obligations of the Company with the sale or maturity of assets or with the occurrence of additional liabilities. Liquidity needs are met with cash on hand, deposits in banks, federal funds sold, securities classified as available for sale and loans maturing within one year. At September 30, 2008, liquid assets totaled \$182,173,000 as compared to \$187,987,000 at December 31, 2007. These amounts represent 38.7% and 40.7% of total liabilities at September 30, 2008 and December 31, 2007, respectively. The Company minimizes liquidity demand by utilizing core deposits to fund asset growth. Securities provide a constant source of liquidity through paydowns and maturities. Also, the Company maintains short-term borrowing arrangements, namely federal funds lines of credit, with larger financial institutions as an additional source of liquidity. Finally, the Bank's membership with the Federal Home Loan Bank of Atlanta provides a source of borrowings with numerous rate and term structures. The Company's senior management monitors the liquidity position regularly and attempts to maintain a position which utilizes available funds most efficiently.

**Table of Contents**

**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

There have been no material changes in Quantitative and Qualitative Disclosures about Market Risk as reported in the 2007 Form 10-K.

**Item 4. Controls and Procedures**

Disclosure Controls and Procedures

The Company, under the supervision and with the participation of management, including the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective as of September 30, 2008 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.

Internal Control over Financial Reporting

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

There were no changes in the Company's internal control over financial reporting during the Company's quarter ended September 30, 2008 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

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

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 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.       |

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized, this 6th day of November, 2008.

**Eagle Financial Services, Inc.**

By: /S/ JOHN R. MILLESON  
John R. Milleson

President and Chief Executive Officer

By: /S/ JAMES W. MCCARTY, JR.  
James W. McCarty, Jr.

Vice President, Chief Financial Officer  
and Secretary-Treasurer