

2013 Annual Report to Shareholders

NORTHWAY FINANCIAL, INC.
2013 ANNUAL REPORT

Table of Contents

Selected Financial Highlights ..... Page 1

Forward-Looking Statements ..... Page 2

2013 Overview ..... Page 2

Consolidated Financial Statements and Notes
to Consolidated Financial Statements ..... Page 4

Independent Auditors' Report ..... Page 43

Selected Financial Highlights

At or for the years ended December 31, ($000 Omitted, except per share data)	2013	2012	2011	2010	2009
Balance Sheet Data:					
Total assets	$898,329	$873,629	$820,539	$831,973	$807,357
Securities available-for-sale, at fair value	184,527	206,703	252,273	158,715	120,252
Loans, net of unearned income	642,259	573,577	500,078	521,341	586,919
Allowance for loan losses	11,190	10,012	10,332	8,658	8,077
Other real estate owned	1,581	1,126	600	1,799	2,568
Goodwill	9,934	9,934	9,934	10,577	10,577
Core deposit intangibles, net	267	352	449	558	785
Deposits	694,359	668,464	611,133	645,820	628,991
Short-term borrowings	35,465	30,270	33,291	39,812	35,271
Long-term debt	80,796	87,656	94,278	83,582	83,620
Stockholders' equity	82,188	80,878	74,892	55,997	51,563
Income Statement Data:					
Net interest and dividend income	$ 28,049	$ 25,779	$ 24,012	$ 24,356	$ 21,711
Provision for loan losses	2,820	2,112	4,660	3,335	2,110
Noninterest income	11,862	11,463	13,350	8,263	6,235
Noninterest expense	27,377	26,891	26,714	24,145	24,875
Net income	7,206	6,494	5,111	4,713	2,033
Net income applicable to common stock	6,925	5,854	4,115	4,068	1,441
Per Common Share Data: (1)(2)					
Net income – basic	$ 2.57	$ 2.23	$ 1.57	$ 1.55	$ 0.56
Net income – assuming dilution	2.57	2.23	1.57	1.55	0.56
Cash dividends declared and paid, common stock	0.64	0.33	0.27	0.24	-
Book value	21.32	21.90	19.57	17.33	15.64
Tangible book value	17.05	17.52	15.27	12.72	11.14
Selected Ratios:					
Return on average assets	0.82 %	0.77 %	0.62 %	0.58 %	0.27 %
Return on average equity	8.89	8.25	7.87	8.65	4.05
Common stock dividend payout	24.82	14.77	17.20	15.46	n/a
Average equity to average assets	9.20	9.31	7.93	6.75	6.54

(1) During 2013, the Company paid one stock dividend of 5%. In 2009, the Company paid three 1.5% stock dividends rather than cash dividends.

(2) Earnings per share and dividends declared per share have been adjusted to reflect the impact of the stock dividends paid.

NATURE OF OPERATIONS

Northway Financial, Inc. ("Northway" or the "Company"), headquartered in North Conway, New Hampshire, is a bank holding company formed in 1997 under the laws of New Hampshire and is registered under the Bank Holding Company Act of 1956. Northway's only business activity has been to own all of the shares of, and provide management, capital and operational support to Northway Bank ("Bank"), its subsidiary headquartered in Berlin, New Hampshire, and its Delaware statutory business trusts, Northway Capital Trust III and Northway Capital Trust IV. Unless the context otherwise requires, references herein to the "Company" include Northway and its subsidiary, the Bank. The Bank is engaged principally in the business of attracting deposits from the general public and investing those deposits in securities, commercial loans, real estate loans and consumer loans.

FORWARD-LOOKING STATEMENTS

Certain statements in this report are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may include, but are not limited to, projections of revenue, income or loss, plans for future operations and acquisitions, projections based on assumptions regarding market and liquidity risk, and plans related to products or services of the Company. Such forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. To the extent any such risks, uncertainties and contingencies are realized, the Company's actual results, performance or achievements could differ materially from anticipated results, performance or achievements. Factors that might affect such forward-looking statements include, among other factors, overall economic and business conditions, economic and business conditions in the Company's market areas, interest rate fluctuations, a prolonged continuation of the current interest rate environment, the demand for the Company's products and services, competitive factors in the industries in which the Company competes, changes in government regulation, and the timing, impact and other uncertainties of future acquisitions.

The words "believe," "expect," "anticipate," "intend," "estimate," "project" or the negative of such terms and other similar expressions which are predictions of or indicate future events and trends and which do not relate to historical matters identify forward-looking statements. Reliance should not be placed on forward-looking statements because they involve known or unknown risks, uncertainties or other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company expressly disclaims any obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Though the Company has attempted to list comprehensively the factors which might affect forward-looking statements, the Company wishes to caution you that other factors may in the future prove to be important in affecting the Company's results of operations. New factors emerge from time to time and it is not possible for management to anticipate all of such factors, nor can it assess the impact of each such factor, or combination of factors, which may cause actual results to differ materially from forward-looking statements.

2013 OVERVIEW

The Company derives substantially all of its revenue and income from community bank-related activities. The Bank does not engage in any specialized finance or capital markets activities. Northway functions primarily as the holder of the common stock of the Bank and assists in the management of the operations of its subsidiary, as appropriate.

The principal component of the Company's income is net interest and dividend income. Net interest and dividend income is the difference between interest and dividend income received on earning assets, such as loans and investments, and the interest expense paid on interest-bearing liabilities, such as deposits and borrowed funds. Its other sources of income include revenues from sales of securities, sales of originated mortgages, deposit account service fees, debit card interchange income, and fee-based services, such as cash management and alternative investments.

Economic and industry factors that could cause the Company's financial performance to differ from expected results, as noted above, include changes in applicable federal and state regulation, changes in general economic conditions or the economy of the Bank's primary market area, interest rate volatility, significant changes in loan losses which may affect the Company's allowance for loan losses and the related provision for loan losses, and changes in the securities market that would affect the performance of the Company's investment portfolio. Management evaluates each of these factors on an ongoing basis to determine their impact and to affect any strategies necessary to mitigate these risks.

2013 OVERVIEW (CONTINUED)

The Company reported net income of $7,206,000 in 2013 compared to net income of $6,494,000 in 2012. In 2013, $6,925,000, or $2.57 per common share, was available to common stockholders compared to $5,854,000, or $2.23 per common share, in 2012. Return on average equity was 8.89% in 2013 compared to 8.25% in 2012. Return on average assets was 0.82% in 2013 compared to 0.77% in 2012.

During 2013, the Company recorded an increase in net interest and dividend income of $2,270,000, as an increase in average earning assets of $40,834,000 and a decrease in the cost of interest-bearing liabilities of 0.28% was partially offset by a decrease in the yield on earning assets of 0.17%. During 2013, interest and dividend income increased $542,000. Average loans increased $91,899,000 while their yield decreased 0.39% resulting in an increase in interest income and fees on loans of $2,288,000. The increase in interest income and fees on loans was partially offset by a decrease in securities income of $1,717,000 resulting from the decrease in average balances of securities available-for-sale of $40,603,000 and a decrease in their average yield of 0.29%. Interest expense decreased $1,728,000 due to a decrease in the rates paid on interest-bearing liabilities of 0.28% partially offset by a net increase in average interest-bearing deposits and borrowings totaling $19,943,000. The provision for loan losses increased $708,000 as the total provision for 2013 was $2,820,000 compared to $2,112,000 for 2012. The increase in the provision for loan losses was the result of the ongoing review of the adequacy of the allowance for loan losses, and was due to the increase in average loans and a target reserve on significant non-performing commercial credits. Noninterest income, excluding net gain on sales of loans and net securities gains, increased $585,000 from 2012 due primarily to increases in NSF overdraft fees, debit card fees and cash management fees. Net gain on sales of loans decreased $212,000 to $2,038,000 compared to $2,250,000 in 2012. The 2012 gains included $366,000 related to the sale of $10,131,000 of portfolio fixed-rate residential mortgage loans. Net gains on sales of securities were $3,815,000 compared to $3,789,000 in 2012. Noninterest expense increased $486,000 in 2013 due primarily to increases in salaries and employee benefits relating to normal salary increases and an increase in pension expense, as well as increases in legal expenses and other real estate owned expenses.

Total assets increased $24,700,000, or 2.8%, to $898,329,000 at December 31, 2013 compared to $873,629,000 at December 31, 2012. The following is a summary of notable balance sheet changes.

	($000 Omitted) December 31			
			Change	
	2013	2012	Amount	Percent
Total assets	$ 898,329	$ 873,629	$ 24,700	2.8
Earning assets	846,117	826,668	19,449	2.4
Securities available-for-sale, at fair value	184,527	206,703	(22,176)	-10.7
Interest-bearing deposits	16,096	41,810	(25,714)	-61.5
Loans, net of unamortized cost/unearned income	642,259	573,577	68,682	12.0
Deposits	694,359	668,464	25,895	3.9
Borrowings	116,261	117,926	(1,665)	-1.4
Stockholders' equity	82,188	80,878	1,310	1.6

The $68,682,000 increase in loans resulted from the Company's expansion into the southern New Hampshire markets of Manchester and Portsmouth. Substantially all of this 12.0% increase in loan balances resulted from increases in the Company's commercial and commercial real estate loan portfolio segments. Loan growth was primarily funded by decreases in the remaining earning asset categories interest-bearing deposits and securities available-for-sale. They decreased by $25,714,000 and $22,176,000, respectively. Combined net growth in deposits and borrowings of $24,340,000 funded substantially all of the 2.8% increase in total assets. Deposits grew by $25,895,000 while borrowings decreased by $1,665,000. The 3.69% increase in deposits resulted primarily from an increased level of listing service CDs. The increase in stockholders' equity was due to net income for the year ended December 31, 2013 of $7,206,000, partially offset by a decrease in other comprehensive income of $3,925,000 and dividends declared and paid to common and preferred stockholders of $1,971,000.

CONSOLIDATED STATEMENTS OF INCOME

FOR THE YEARS ENDED DECEMBER 31,	($000 Omitted, except per share data) 2013	2012
Interest and dividend income		
Interest and fees on loans	$ 28,367	$ 26,079
Interest on debt securities available-for-sale		
Taxable	2,983	4,568
Tax-exempt	1,336	1,457
Dividends	286	297
Interest on interest-bearing deposits	57	86
Total interest and dividend income	33,029	32,487
Interest expense		
Interest on deposits	2,608	4,095
Interest on short-term borrowings	78	47
Interest on long-term debt	2,294	2,566
Total interest expense	4,980	6,708
Net interest and dividend income	28,049	25,779
Provision for loan losses	2,820	2,112
Net interest and dividend income after provision for loan losses	25,229	23,667
Noninterest income		
Service charges and fees on deposit accounts	2,431	2,294
Debit card fees	1,551	1,434
Gain on sales and calls of securities available-for-sale, net	3,815	3,789
Gain on sales of loans, net	2,038	2,250
Other	2,027	1,696
Total noninterest income	11,862	11,463
Noninterest expense		
Salaries and employee benefits	15,837	15,155
Office occupancy and equipment	3,223	3,098
Amortization of core deposit intangibles	85	97
Other	8,232	8,541
Total noninterest expense	27,377	26,891
Income before income tax expense	9,714	8,239
Income tax expense	2,508	1,745
Net income	$ 7,206	$ 6,494
Net income available to common stockholders	$ 6,925	$ 5,854
Basic earnings per common share	$ 2.57	$ 2.23
Earnings per common share assuming dilution	$ 2.57	$ 2.23

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED DECEMBER 31,	($000 Omitted) 2013	2012
Net income	$ 7,206	$ 6,494
Other comprehensive (loss)/income		
Net unrealized (losses)/gains on securities available-for-sale	(3,843)	5,085
Reclassification adjustment for realized gains in net income	(3,815)	(3,789)
Net unrealized (losses)/gains on securities	(7,658)	1,296
Pension valuation adjustment	1,278	119
Pension prior service credit adjustment	(83)	(85)
Derivative valuation adjustment	-	218
Investment in limited partnership valuation adjustment	(37)	50
Other comprehensive (loss)/income	(6,500)	1,598
Income tax (benefit)/provision	(2,575)	633
Other comprehensive (loss)/income, net of tax	(3,925)	965
Comprehensive income	$ 3,281	$ 7,459

See Notes to Consolidated Financial Statements

Reclassification adjustments are comprised of realized security gains and losses, pension valuation adjustments, and realized gains and losses in a limited partnership investment. The gains and losses have been reclassified out of accumulated other comprehensive income and have affected certain lines in the consolidated statements of operations as follows: the pre-tax amount of securities is included in gain on sales and calls of securities available-for-sale, net, and the pension valuation, pension prior service credit and investment in limited partnership valuation adjustments are included in other noninterest expense. The tax expense amounts associated with these adjustments are included in income tax expense, and the after tax amounts are included in net income.

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31,	($000 Omitted) 2013	2012
Assets		
Cash and cash equivalents		
Cash and due from banks and interest-bearing deposits	$ 29,423	$ 49,385
Total cash and cash equivalents	29,423	49,385
Interest-bearing time deposits with other banks	3,968	4,712
Securities available-for-sale, at fair value	184,527	206,703
Federal Home Loan Bank of Boston stock	5,045	5,176
Loans held-for-sale	1,595	3,656
Loans, net before allowance for loan losses	642,259	573,577
Less: allowance for loan losses	11,190	10,012
Net loans	631,069	563,565
Premises and equipment, net	14,135	13,051
Other real estate owned	1,581	1,126
Goodwill	9,934	9,934
Core deposit intangibles, net	267	352
Other assets	16,785	15,969
Total assets	$ 898,329	$ 873,629
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Demand	$ 83,901	$ 82,250
Regular savings, NOW and money market deposit accounts	406,964	410,585
Certificates of deposit (in denominations of $100,000 or more)	92,813	64,398
Other time	110,681	111,231
Total deposits	694,359	668,464
Short-term borrowings	35,465	30,270
Long-term debt	80,796	87,656
Other liabilities	5,521	6,361
Total liabilities	816,141	792,751
Stockholders' equity		
Preferred stock, $1.00 par value; 1,000,000 shares authorized;		
Preferred stock, senior non-cumulative perpetual, Series C, par value $1.00 per share; 23,593 shares issued and outstanding at December 31, 2013 and December 31, 2012; liquidation value $1,000 per share	24	24
Common stock, $1.00 par value; 9,000,000 shares authorized; 3,800,438 and 3,619,601 shares shares issued at December 31, 2013 and December 31, 2012, respectively, and 2,751,650 and 2,620,755 outstanding at December 31, 2013 and December 31, 2012, respectively	3,800	3,620
Additional paid-in-capital	27,640	25,013
Retained earnings	70,614	68,186
Treasury stock (1,048,788 and 998,846 shares at December 31, 2013 and December 31, 2012, respectively)	(15,470)	(15,470)
Accumulated other comprehensive loss, net of tax	(4,420)	(495)
Total stockholders' equity	82,188	80,878
Total liabilities and stockholders' equity	$ 898,329	$ 873,629

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

($000 Omitted)

	Preferred Stock Series C	Common Stock	Additional Paid-in-Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balance at December 31, 2011	$ 24	$ 3,620	$ 24,981	$ 63,197	$ (15,470)	$ (1,460)	$ 74,892
Net income - 2012	-	-	-	6,494	-	-	6,494
Preferred stock accretion (amortization)	-	-	32	(32)	-	-	-
Net change in accumulated other comprehensive loss, net of taxes	-	-	-	-	-	965	965
Cash dividend declared on preferred stock Series C	-	-	-	(608)	-	-	(608)
Cash dividends declared on common stock ($0.33 per share)	-	-	-	(865)	-	-	(865)
Balance at December 31, 2012	$ 24	$ 3,620	$ 25,013	$ 68,186	$ (15,470)	$ (495)	$ 80,878
Net income - 2013	-	-	-	7,206	-	-	7,206
Stock dividend - common stock	-	180	2,595	(2,775)	-		-
Preferred stock accretion (amortization)	-	-	32	(32)	-	-	-
Net change in accumulated other comprehensive loss, net of taxes	-	-	-	-	-	(3,925)	(3,925)
Cash dividend declared on preferred stock Series C	-	-	-	(249)	-	-	(249)
Cash dividends declared on common stock ($0.64 per share)	-	-	-	(1,722)	-	-	(1,722)
Balance at December 31, 2013	$ 24	$ 3,800	$ 27,640	$ 70,614	$ (15,470)	$ (4,420)	$ 82,188

See Notes to Consolidated Financial Statements

At December 31, accumulated other comprehensive loss, net of taxes, consists of the following:

	($000 Omitted) 2013	2012
Net unrealized holding (losses)/gains on available-for-sale securities	$ (2,056)	$ 2,568
Net unrealized loss on pension valuation	(2,468)	(3,240)
Net credit for prior service on pension	70	121
Net gain on investment in a limited partnership	34	56
	$ (4,420)	$ (495)

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEAR ENDED DECEMBER 31,	($000 Omitted) 2013	2012
Cash flows from operating activities:		
Net income	$ 7,206	$ 6,494
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,820	2,112
Depreciation and amortization	1,305	1,315
Deferred income tax expense	1,050	1,835
Gain on sales and calls of securities available-for-sale, net	(3,815)	(3,789)
Write-down of other real estate owned	46	108
Loss on sale, disposal and write-down of premises and equipment	56	5
Amortization of premiums and accretion of discounts on securities available-for-sale, net	2,111	2,026
Amortization of deferred prepayment penalty on FHLBB advances	140	135
Change in unearned income/unamortized cost, net	196	(19)
Gain on sales of other real estate owned and other personal property, net	(88)	(64)
Gain on sales of loans not originated for sale	-	(287)
Net decrease (increase) in loans held-for-sale	2,061	(2,591)
Net change in other assets and other liabilities	1,136	(1,224)
Net cash provided by operating activities	14,224	6,056
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	47,935	95,260
Proceeds from maturities of securities available-for-sale	33,128	75,281
Purchase of securities available-for-sale	(64,841)	(121,912)
Purchase of FHLBB stock	(77)	(60)
Redemption of FHLBB stock	208	225
Redemption of interest-bearing time deposits	744	248
Capital redemption (investment) on investment in limited partnership	3	(7)
Loan originations and principal collections, net	(63,301)	(74,347)
Purchase of loans, net of principal collections	(8,459)	(13,373)
Recoveries of previously charged-off loans	210	545
Proceeds from sale of residential mortgage loans	-	10,418
Proceeds from sales of and payments received on other real estate owned	1,146	495
Proceeds from sales of and payments received on other personal property	24	1
Additions to premises and equipment and software, net of disposals	(2,952)	(2,788)
Net cash used by investing activities	(56,232)	(30,014)
Cash flows from financing activities:		
Net increase in deposits	25,895	57,331
Net increase (decrease) in short-term borrowings	5,195	(3,021)
Advances from FHLBB	7,000	7,500
Repayment of FHLBB advances	(14,000)	(14,000)
Prepayment penalty-restructured FHLBB advances	-	(257)
Cash dividends paid	(2,044)	(1,631)
Net cash provided by financing activities	22,046	45,922
Net (decrease) increase in cash and cash equivalents	(19,962)	21,964
Cash and cash equivalents at beginning of year	49,385	27,421
Cash and cash equivalents at end of year	$ 29,423	$ 49,385

See Notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

FOR THE YEAR ENDED DECEMBER 31,	($000 Omitted) 2013	2012
Supplemental disclosure of cash flow information:		
Interest paid	$ 4,993	$ 6,780
Taxes paid	450	520
Non-cash investing and financing activities:		
Loans transferred to other real estate owned	1,507	1,665
Loans transferred to other personal property	10	67
Loans originated to finance sales of other real estate owned	-	600
Premises transferred to bank-owned other real estate owned	487	-

See Notes to Consolidated Financial Statements

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Northway Financial, Inc. ("Northway"), headquartered in North Conway, New Hampshire, is a bank holding company formed in 1997 under the laws of New Hampshire and is registered under the Bank Holding Company Act of 1956. Northway's only business activity has been to own all of the shares of, and provide management, capital and operational support to Northway Bank ("Bank"), its subsidiary headquartered in Berlin, New Hampshire, and its Delaware statutory business trusts, Northway Capital Trust III and Northway Capital Trust IV. Unless the context otherwise requires, references herein to the "Company" include Northway and its subsidiary, the Bank. The Bank is engaged principally in the business of attracting deposits from the general public and investing those deposits in securities, commercial loans, real estate loans and consumer loans.

Basis of Presentation

The consolidated financial statements include the accounts of Northway and the Bank. All significant intercompany accounts and transactions have been eliminated in the consolidation.

Northway Capital Trust III and Northway Capital Trust IV, affiliates of the Company, were formed to sell capital securities to the public through a third party trust pool. In accordance with Accounting Standards Codification ("ASC") 810-10, "Consolidation-Overall," these affiliates have not been included in the consolidated financial statements.

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

In preparing the financial statements, management is required to make estimates and judgments that affect the reported amounts of assets and liabilities as of the dates of the consolidated balance sheets, and income and expense for the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to change in the near-term relate to the determination of the allowance for loan losses.

Reclassifications

Certain amounts in the prior years' financial statements have been reclassified to conform with the current year's presentation.

Cash and Cash Equivalents

For purposes of the statement of cash flows, cash and cash equivalents include cash and due from banks and interest-bearing deposits.

Securities

Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost; if debt and equity securities are bought and held principally for the purpose of selling in the near term they are classified as trading and reported at fair value, with unrealized gains and losses included in earnings; and debt and equity securities not classified as either held-to-maturity or trading are classified as available-for-sale and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity, net of estimated income taxes. At this time, the Company has not established a trading account.

Premiums and discounts are amortized and accreted primarily on the level yield method over the contractual lives of the securities, adjusted for expected prepayments.

For any debt security with a fair value less than its amortized cost basis, the Company will determine whether it has the intent to sell the debt security or whether it is more likely than not it will be required to sell the debt security before the recovery of its amortized cost basis. If either condition is met, the Company will recognize a full impairment charge to earnings. For all other debt securities that are considered other-than-temporarily impaired and do not meet either condition, the credit loss portion of impairment will be recognized in earnings as realized losses. The other-than-temporary impairment related to all other factors will be recorded in other comprehensive income.

Declines in marketable equity securities below their cost that are deemed other than temporary are reflected in earnings as realized losses.

As a member of the Federal Home Loan Bank of Boston ("FHLBB"), the Bank is required to invest in $100 par value stock of the FHLBB. The FHLBB capital structure mandates that members must own stock as determined by their Total Stock Investment Requirement which is the sum of a member's Membership Stock Investment Requirement and Activity-Based Stock Investment Requirement. The Membership Stock Investment Requirement is calculated as 0.35% of a member's Stock Investment Base, subject to a minimum investment of $10,000 and a maximum investment of $25,000,000. The Stock Investment Base is an amount calculated based on certain assets held by a member that are reflected on call reports submitted to applicable regulatory authorities. The Activity-Based Stock Investment Requirement is calculated as 4.5% of a member's outstanding principal balances of FHLBB advances plus a percentage of advance commitments, 4.5% of standby letters of credit issued by the FHLBB and 4.5% of the value of intermediated derivative contracts. Management evaluates the Bank's investment in FHLBB stock for other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such evaluation. Based on its most recent analysis of the FHLBB as of December 31, 2013, management deems its investment in FHLBB stock to be not other-than-temporarily impaired.

Gains and losses on sales of securities available-for-sale are recognized at the time of the sale on a specific identification basis.

Loans Held-for-Sale

Loans held-for-sale are generally identified as such at origination and are stated at the lower of aggregate cost or market value. Market value is based on outstanding investor commitments. When loans are sold, a gain or loss is recognized to the extent that the sale proceeds exceed or are less than the carrying value of the loans. Gains and losses are determined using the specific identification method. All loans sold are without recourse to the Company.

Loans

Loans are carried at the principal amounts outstanding, net of any unearned income or unamortized cost, premiums on originated loans and discounts on acquired loans. Unearned income and unamortized cost includes loan origination fees, net of direct loan origination costs. This income or expense is deferred and recognized as adjustments to loan income over the contractual lives of the related notes using a method, the result of which approximates that of the interest method.

Loans are placed on nonaccrual status when payment of principal or interest is considered to be in doubt or is past due 90 days or more. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired, if (i) it is probable that the Company will collect all amounts due in accordance with the contractual terms of the loan or (ii) the loan is not a commercial, commercial real estate or an individually significant residential mortgage or consumer loan. Previously accrued income on nonaccrual loans that has not been collected is reversed from current income, and subsequent cash receipts are recorded as income if principal on the loans is deemed collectible. Loans are returned to accrual status when collection of all contractual principal and interest is reasonably assured and there has been sustained repayment performance. Further, the Company evaluates and classifies as troubled debt restructuring ("TDR")/special mention/substandard/doubtful loans modified by means of extended maturity, below market adjusted interest rates, a combination of rate and maturity, or by other means including covenant modifications, forbearance and/or other concessions.

The Company's loans are primarily secured by real estate in New Hampshire. In addition, other real estate owned is located in this market. Accordingly, the ultimate collectability of a substantial portion of the Company's loan portfolio and the recovery of other real estate owned are susceptible to changing conditions in this market.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses consists of general, allocated and unallocated components, as further described below.

General component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following ten loan segments: residential real estate, residential construction, hospitality and campground loans, loans to restaurants, commercial real estate net of hospitality and campground loans and loans to restaurants, commercial real estate construction, commercial, municipal and consumer. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company's policies or methodology pertaining to the general component of the allowance for loan losses during 2013.

The qualitative factors are determined based on the various risk characteristics of each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential real estate - The Company generally does not originate loans with a cumulative loan-to-value ratio greater than 80 percent and does not make loans it considers to be "subprime." Loans in this segment are first lien mortgages collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment.

Construction - Loans in this segment are comprised of residential construction and commercial real estate construction loans. For residential construction loans, the Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not make loans it considers to be "subprime." Residential loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. These construction loans convert to permanent residential real estate mortgages at the end of the construction term. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment. Commercial real estate construction loans primarily include real estate development loans that convert to investor-owned and owner-occupied permanent financing. Loans in this segment are primarily income-producing properties throughout New Hampshire.

Hospitality and campground loans - Loans in this segment are primarily income-producing properties in New Hampshire made to hotels, motels, campgrounds and like hospitality companies. The underlying cash flows generated by the properties are adversely impacted by a downturn in the economy as evidenced by reduced room occupancy and rates, which in turn, will have an impact on the credit quality in this segment.

Loans to restaurants - Loans in this segment are primarily income-producing properties in New Hampshire made to restaurants. The underlying cash flows generated by the properties rely on tourism and are adversely impacted by a downturn in the economy.

Commercial real estate - This segment is net of hospitality and campground and restaurant loans and is subject to higher qualitative underwriting factors due to the level of concentration and possible credit risk. Loans in this segment are primarily income-producing investor-owned or owner-occupied business properties throughout New Hampshire. The underlying cash flows generated by the investor-owned properties are adversely impacted by a downturn in the economy. Management obtains annual and interim financial information, as well as rent rolls annually, and continually monitors the cash flows of these loans.

Commercial loans - This segment is net of hospitality and campground and restaurant loans and is subject to higher qualitative underwriting factors due to the level of concentration and possible credit risk. Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer spending, will have an effect on the credit quality in this segment.

Consumer loans - Loans in this segment are comprised primarily of home equity loans, which can be either first or second lien mortgages. The Company generally does not originate loans with a cumulative loan-to-value ratio greater than 80 percent and does not make loans it considers to be "subprime." Loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment. The remainder of this segment is comprised of unsecured loans and repayment is dependent on the credit quality of the individual borrower.

Municipal loans - Loans in this segment are generally unsecured and repayment is dependent on the tax assessments of the local municipalities, which can be adversely impacted in a weakened economy.

Allocated component

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for commercial, commercial real estate and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is specifically allocated when the discounted cash flows (or collateral value) of the impaired loan is lower than the carrying value of that loan. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential real estate loans for impairment disclosures, unless such loans are subject to a TDR agreement.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and a concession is made to a borrower experiencing financial difficulty, the modification is considered a TDR. All TDRs are initially classified as impaired. These loans are evaluated under the same measurements used for impaired loans.

Unallocated component

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general reserves in the portfolio.

Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum (i.e. homogeneous grouping), to the extent that fair value is less than the capitalized amount for the stratum.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the respective assets. Estimated lives are thirty-nine years for buildings, ten to fifteen years for building improvements and three to seven years for furniture and equipment.

Amortization of leasehold improvements is computed on a straight-line basis generally over the lesser of the term of the respective lease or the asset's useful life, which is not to exceed ten years.

Other Real Estate Owned

Other real estate owned is comprised of properties acquired either through foreclosure proceedings or acceptance of a deed in lieu of foreclosure, and for which the Company has taken physical possession, as well as former banking premises for which banking use is no longer contemplated. The Company classifies loans as repossessed or foreclosed if the Company receives physical possession of the debtor's assets, regardless of whether or not foreclosure proceedings take place.

Assets acquired through foreclosure or a similar conveyance of title are initially recorded at fair value, less estimated costs to sell, of the property constructively or actually received. If the property is held for greater than one year, an appraisal is performed annually to update the market value of the property to adjust the carrying value of the property to fair market value less estimated costs to sell, if such value is below carrying value. Gains and losses upon disposition are reflected in the statement of income as realized.

Advertising

The Company directly expenses costs associated with advertising as they are incurred.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Company recognizes interest and penalties, if any, related to the underpayment of income taxes in income tax expense.

Earnings Per Share

Basic earnings per share ("EPS") excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS, if applicable, reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

Earnings per common share have been computed based on the following:

	($000 Omitted, Shares Reported in Thousands) Years Ended December 31,	
	2013	2012
Net income	$ 7,206	$ 6,494
Preferred stock net accretion	(32)	(32)
Preferred stock dividends	(249)	(608)
Net income applicable to common stock	$ 6,925	$ 5,854
Average number of common shares outstanding	2,698.2	2,620.8
Effect of dilutive options	-	-
Average number of common shares outstanding used to calculate diluted earnings per common share	2,698.2	2,620.8

Preferred Stock

On September 15, 2011, Northway issued shares of its Series C preferred stock to the United States Department of the Treasury under the Small Business Lending Fund program (the "SBLF") in exchange for $23,593,000 in capital from the SBLF. The SBLF program is a $30 billion fund established under the Small Business Jobs Act of 2010 to encourage lending to small businesses by providing Tier 1 capital to qualified community banks with assets of less than $10 billion. The preferred stock qualifies as Tier 1 capital for regulatory purposes and ranks senior to Northway's common stock.

The Series C preferred stock pays non-cumulative dividends. The dividend rate on the Series C preferred stock for the initial quarterly dividend period ending September 30, 2011 and each of the next nine quarterly dividend periods the Series C preferred stock is outstanding is determined each quarter based on the increase in the Bank's Qualified Small Business Lending (as defined in the SBLF Purchase Agreement). The average dividend rate for the year ended December 31, 2013 was 1.05%. For the tenth quarterly dividend period through four and one-half years after its issuance, the dividend rate on the Series C preferred stock will be fixed at 1.0% per annum, and after four and one-half years from its issuance the dividend rate will be fixed at 9.0% per annum. The Series C preferred stock is non-voting, other than voting rights on matters that could adversely affect the Series C preferred stock.

The Series C preferred stock may be redeemed at any time by the Company, subject to the approval of its federal banking regulator. The redemption price is the aggregate liquidation preference of the Series C preferred stock plus accrued but unpaid dividends and pro rata portion of any lending incentive fee. All redemptions must be in an amount at least equal to 25% of the number of originally issued shares of Series C preferred stock, or 100% of the then-outstanding shares if less than 25% of the number of shares originally issued.

Recent Accounting Pronouncements

In December 2011, the Financial Accounting Standards Board (FASB) issued ASU 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities." The objective of this ASU is to enhance current disclosures. Entities are required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. The amendments in this ASU are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of this guidance did not have a material impact on the Company's financial statements.

In February 2013, the FASB issued ASU 2013-02, "Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income." The amendments in this update do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under United States Generally Accepted Accounting Principles ("U.S. GAAP") to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. Early adoption is permitted. The adoption of ASU 2013-02 did not have a material impact on the Company's financial statements.

In July 2013, the FASB issued ASU 2013-10, "Derivatives and Hedging (Topic 815): Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes." The amendments in this ASU permit the Fed Funds Effective Swap Rate (OIS) to be used as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to Treasury Obligations of the U.S. government (UST) and the London Interbank Offered Rate (LIBOR). The amendments also remove the restriction on using different benchmark rates for similar hedges. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under Topic 815. The amendments are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this ASU did not have an impact on the Company's results of operations or financial position.

In July 2013, the FASB issued ASU 2013-11, "Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists." The amendments in this ASU provide guidance for the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The amendments in this ASU are expected to reduce diversity in practice by providing guidance on the presentation of unrecognized tax benefits and will better reflect the manner in which an entity would settle at the reporting date any additional income taxes that would result from the disallowance of a tax position when net operating loss carryforwards, similar tax losses, or tax credit carryforwards exist. The amendments apply to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this guidance is not expected to have an impact on the Company's results of operations or financial position.

In January 2014, the FASB issued ASU 2014-04, "Receivables-Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure." The objective of the amendments in this ASU is to reduce diversity by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this ASU using either a modified retrospective transition method or a prospective transition method. The Company is reviewing this ASU to determine if there will be a material impact on the Company's consolidated financial statements.

NOTE 2 CASH AND DUE FROM BANKS

During 2013, the Federal Reserve eliminated the contractual clearing balance program, and as a result, no amounts were subject to withdrawal and usage restrictions as of December 31, 2013. At December 31, 2012, $1,094,000 was subject to withdrawal and usage restrictions to satisfy the reserve requirements of the Federal Reserve Bank, in effect at the time.

NOTE 3 SECURITIES AVAILABLE-FOR-SALE

The amortized cost, gross unrealized gains, gross unrealized losses, and fair value of securities at December 31, 2013 and 2012 follow:

	($000 Omitted)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2013				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 19,441	$ -	$ 1,360	$ 18,081
U.S. government agency and sponsored enterprise mortgage-backed securities	95,460	271	2,187	93,544
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	3,730	6	45	3,691
State and political subdivision bonds	59,385	507	1,762	58,130
Collateralized mortgage obligations issued by others	1	-	-	1
Marketable equity securities	9,915	1,240	75	11,080
	$ 187,932	$ 2,024	$ 5,429	$ 184,527
December 31, 2012				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 10,798	$ 155	$ 2	$ 10,951
U.S. government agency and sponsored enterprise mortgage-backed securities	113,720	2,344	73	115,991
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	6,346	54	35	6,365
State and political subdivision bonds	58,916	3,239	193	61,962
Collateralized mortgage obligations issued by others	1	-	-	1
Marketable equity securities	10,129	636	245	10,520
Trust-preferred securities	2,540	-	1,627	913
	$ 202,450	$ 6,428	$ 2,175	$ 206,703

NOTE 3 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

The contractual maturity distribution of investments in debt obligations at December 31, 2013 follows:

	($000 Omitted)				
	Within One Year	Over One Through Five Years	After Five Through Ten Years	Over Ten Years	Total Amortized Cost
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ -	$ -	$ 10,796	$ 8,645	$ 19,441
U.S. government agency and sponsored enterprise mortgage-backed securities	-	-	4,620	90,840	95,460
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	-	-	1,891	1,839	3,730
State and political subdivision bonds	-	-	3,541	55,844	59,385
Collateralized mortgage obligations issued by others	-	1	-	-	1
Total amortized cost	$ -	$ 1	$ 20,848	$157,168	$178,017
Fair value	$ -	$ 1	$ 20,445	$153,001	$173,447

Actual maturities of U.S. government agency and sponsored enterprise mortgage-backed securities, collateralized mortgage obligations and state and political subdivision bonds will differ from the maturities presented because borrowers have the right to prepay obligations with or without prepayment penalties.

For the years ended December 31, 2013 and 2012, gross proceeds from the sales of securities available-for-sale amounted to $47,935,000 and $95,260,000, respectively. An analysis of gross realized gains and losses on sales of securities available-for-sale during the years ended December 31, follows:

	($000 Omitted)			
	2013		2012	
	Realized Gains	Realized Losses	Realized Gains	Realized Losses
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ -	$ -	$ 155	$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	341	-	1,602	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	4	-	-	-
State and political subdivision bonds	1,299	-	1,241	-
Marketable equity securities	2,143	48	869	143
Trust-preferred securities	76	-	-	-
	$ 3,863	$ 48	$ 3,867	$ 143

The tax provision applicable to these net realized gains amounted to $1,511,000 and $1,475,000 for 2013 and 2012, respectively.

Securities with a carrying amount totaling $151,818,000 and $132,104,000 were pledged to secure public deposits, securities sold under agreements to repurchase and FHLBB advances at December 31, 2013 and 2012, respectively.

The aggregate fair value and unrealized losses of securities that have been in a continuous unrealized loss position for less than twelve months and for twelve months or more are as follows as of December 31, including debt securities for which a portion of other-than-temporary impairment has been recognized in other comprehensive income:

NOTE 3 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

	($000, Omitted)					
	Less than 12 Months		12 Months or Longer		Total	
December 31, 2013	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 18,081	$ 1,360	$ -	$ -	$ 18,081	$ 1,360
U.S. government agency and sponsored enterprise mortgage-backed securities	76,816	2,077	3,459	110	80,275	2,187
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	2,019	10	848	35	2,867	45
State and political subdivision bonds	23,448	1,204	5,426	558	28,874	1,762
Marketable equity securities	1,957	62	126	13	2,083	75
Total temporarily impaired securities	$122,321	$ 4,713	$ 9,859	$ 716	$132,180	$ 5,429
December 31, 2012						
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 1,036	$ 2	$ -	$ -	$ 1,036	$ 2
U.S. government agency and sponsored enterprise mortgage-backed securities	7,617	73	-	-	7,617	73
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	985	35	-	-	985	35
State and political subdivision bonds	10,694	193	-	-	10,694	193
Marketable equity securities	3,205	187	622	58	3,827	245
Total temporarily impaired securities	23,537	490	622	58	24,159	548
Other-than-temporarily impaired debt securities						
Trust-preferred securities	-	-	913	1,627	913	1,627
Total temporarily-impared and other-than-temporarily impaired securites	$ 23,537	$ 490	$ 1,535	$ 1,685	$ 25,072	$ 2,175

At December 31, 2013, securities with a total fair value of $132,180,000 were in a loss position. These securities included ten U.S. government agency securities with a fair value of $18,081,000 and an unrealized loss of $1,360,000. These securities had an unrealized loss due to the current interest rate environment. As these securities are guaranteed by Federal Farm Credit Bank ("FFCB") or Federal National Mortgage Association ("FNMA") there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Twenty-three U.S. government agency and sponsored enterprise mortgage-backed securities with a fair value of $80,275,000 had an unrealized loss of $2,187,000 at December 31, 2013. These securities had a loss due to the current interest rate environment. As these securities are guaranteed by U.S. government agencies or government-sponsored enterprises such as the Government National Mortgage Association ("GNMA"), Federal Home Loan Mortgage Corporation ("FHLMC") or FNMA there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Three collateralized mortgage obligations with a fair value of $2,867,000 had an unrealized loss of $45,000 at December 31, 2013. These securities had an unrealized loss due to the current interest rate environment. As these collateralized mortgage obligations are government-sponsored enterprise bonds issued by the Small Business Investment Conduit ("SBIC") or GNMA, there is little or no credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability and intent to hold them until cost recovery.

Fifty-four state and political subdivision securities with a fair value of $28,874,000 had an unrealized loss of $1,762,000 at December 31, 2013. All of these state and political subdivision securities are guaranteed by municipalities and there is minimal credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability to hold them until cost recovery.

Seventeen marketable equity securities with a fair value of $2,083,000 had an unrealized loss of $75,000 at December 31, 2013. Marketable equity securities are subject to internal testing on a quarterly basis to determine impairment. Testing includes review of industry analyst reports, credit ratings, sector analysis and earnings projections. Based upon the December 31, 2013 review, these securities have been classified as not other-than-temporarily impaired.

NOTE 3 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

Activity related to the credit component recognized in earnings on debt securities held by the Company for which a portion of other-than-temporary impairment was recognized in other comprehensive income for the years ended December 31 is as follows:

	($000 Omitted)	
	2013	2012
Beginning balance (1)	$ 2,057	$ 2,057
Deduct: Amounts related to the sale of debt securities in which other-than-temporary impairment was not previously recognized	(2,057)	-
Ending balance	$ -	$ 2,057

(1) The beginning balance represents the amount related to credit losses in debt securities held by the Company at the beginning of the period for which a portion of an other-than-temporary impairment was recognized in other comprehensive income.

NOTE 4 LOANS

Loan balances were comprised of the following:

	($000 Omitted)	
December 31,	2013	2012
Real estate:		
Residential	$ 140,951	$ 131,145
Commercial	251,402	205,117
Construction	41,865	34,749
Commercial	117,497	107,747
Consumer	52,268	51,886
Municipal	38,403	42,864
Total loans	642,386	573,508
Unamortized (fees)/costs	(127)	69
Allowance for loan losses	(11,190)	(10,012)
Total unamortized (fees)/costs and allowance for loan losses	(11,317)	(9,943)
Net loans	$ 631,069	$ 563,565

Loans are made in the ordinary course of business to directors, executive officers, and their immediate families and to organizations in which such persons have more than a 10% ownership interest. These loans are made on substantially the same terms, including interest rate and collateral, as those prevailing at the same time for comparable transactions with unrelated persons and did not involve more than the normal risk of collectibility or present other unfavorable features. The total of such loans amounted to $378,000 as of December 31, 2013. During 2013, the outstanding balance decreased $79,000 due to change in status, principal payments were $457,000 and principal advances amounted to $278,000.

The Company's lending activities are conducted principally in New Hampshire. Although the loan portfolio is diversified, a portion of its debtors' ability to repay is dependent upon the economic conditions prevailing in New Hampshire. The Company maintains significant credit relationships with borrowers in the hotel and motel industry. The aggregate loan balances to these industries totaled $92,210,000 and $86,603,000 at December 31, 2013 and 2012, respectively.

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans total $292,128,000 and $228,957,000 at December 31, 2013 and 2012, respectively. The Company sold $64,780,000 of mortgage loans in 2013 and $95,731,000 of mortgage loans in 2012. The mortgage loans sold in 2012 included $9,869,000 of portfolio loans that were sold to a third-party investor.

The Company capitalized $887,000 and $779,000 of servicing rights and amortized $557,000 and $509,000 of servicing rights in 2013 and 2012, respectively. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate, as a level 3 asset. At December 31, 2013 and 2012, respectively, the carrying amount of servicing rights was $1,551,000 and $1,179,000, and is included in other assets. At December 31, 2013 and 2012, respectively, the fair value of servicing rights was $2,179,000 and $1,539,000.

NOTE 4 LOANS (CONTINUED)

Following is an analysis of the aggregate changes in the valuation allowance for mortgage servicing rights for the years ended December 31:

	($000 Omitted)	
	2013	2012
Beginning balance	$ 81	$ 90
Additions	74	142
Reductions	(116)	(151)
Ending balance	$ 39	$ 81

The following table is an aging analysis of the recorded investment in past due loans and nonaccrual loans as of December 31, 2013 and 2012.

	($000 Omitted)				
	Aging Analysis of Past Due Loans				
December 31, 2013	30–59 Days	60–89 Days	90 Days or More	Total Past Due	Nonaccrual Loans
Real estate:					
Residential	$ 1,617	$ 304	$ 320	$ 2,241	$ 1,917
Commercial	356	66	2,870	3,292	6,703
Construction	115	-	294	409	410
Commercial	327	33	891	1,251	4,636
Consumer	524	43	138	705	538
Total	$ 2,939	$ 446	$ 4,513	$ 7,898	$ 14,204

December 31, 2012	30–59 Days	60–89 Days	90 Days or More	Total Past Due	Nonaccrual Loans
Real estate:					
Residential	$ 1,045	$ 329	$ 1,051	$ 2,425	$ 2,692
Commercial	533	675	3,601	4,809	7,075
Construction	296	122	-	418	-
Commercial	1,784	197	1,605	3,586	1,969
Consumer	404	23	60	487	458
Total	$ 4,062	$ 1,346	$ 6,317	$ 11,725	$ 12,194

NOTE 4 LOANS (CONTINUED)

The following table summarizes, for the years ended December 31, 2013 and 2012, the recorded investment in impaired loans, the unpaid principal balance, any related allowance for loan losses, the average recorded investment and interest income recognized.

	($000 Omitted)				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2013					
With no related allowance recorded:					
Real estate:					
Residential	$ 476	$ 580	$ -	$ 601	$ 22
Commercial	3,735	5,726	-	8,806	277
Commercial	798	2,839	-	1,130	16
Total impaired with no related allowance	5,009	9,145	-	10,537	315
With an allowance recorded:					
Real estate:					
Residential	101	101	4	82	1
Commercial	2,287	2,560	387	2,241	7
Construction	295	295	160	236	1
Commercial	3,328	3,364	1,675	2,765	12
Total impaired with an allowance recorded	6,011	6,320	2,226	5,324	21
Total:					
Real estate:					
Residential	577	681	4	683	23
Commercial	6,022	8,286	387	11,047	284
Construction	295	295	160	236	1
Commercial	4,126	6,203	1,675	3,895	28
Total impaired loans	$ 11,020	$ 15,465	$ 2,226	$ 15,861	$ 336
December 31, 2012					
With no related allowance recorded:					
Real estate:					
Residential	$ 555	$ 555	$ -	$ 667	$ 19
Commercial	12,704	13,598	-	12,215	425
Construction	-	-	-	277	-
Commercial	1,945	2,201	-	2,620	75
Total impaired with no related allowance	15,204	16,354	-	15,779	519
With an allowance recorded:					
Real estate:					
Residential	329	329	13	249	5
Commercial	2,800	2,945	792	1,848	54
Commercial	595	1,390	498	1,033	-
Total impaired with an allowance recorded	3,724	4,664	1,303	3,130	59
Total:					
Real estate:					
Residential	884	884	13	916	24
Commercial	15,504	16,543	792	14,063	479
Construction	-	-	-	277	-
Commercial	2,540	3,591	498	3,653	75
Total impaired loans	$ 18,928	$ 21,018	$ 1,303	$ 18,909	$ 578

NOTE 4 LOANS (CONTINUED)

Included in certain loan categories in the impaired loans are TDRs that were classified as impaired. TDR loans may be modified by means of extended maturity, below market adjusted interest rates, a combination of rate and maturity, or by other means including covenant modifications, forbearance and/or other concessions.

The following tables provide information on how loans were modified as TDRs during the years ended December 31:

($000 Omitted)
2013

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment	Terms of Modification: Extended Maturity	Terms of Modification: Adjusted Interest Rate	Terms of Modification: Combination of Rate and Maturity	Terms of Modification: Other
Troubled debt restructurings:							
Real estate:							
Commercial	2	$ 274	$ 384	$ 274	$ -	$ -	$ 110
Commercial	6	3,295	3,363	-	3,295	-	68
Consumer	-	-	-	-	-	-	
	8	$ 3,569	$ 3,747	$ 274	$ 3,295	$ -	$ 178

	2013 Number of Contracts	2013 Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Troubled debt restructurings:		
Real estate:		
Residential	2	$ 288
Commercial	2	1,705
Commercial	1	67
	5	$ 2,060

($000 Omitted)
2012

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment	Terms of Modification: Extended Maturity	Terms of Modification: Adjusted Interest Rate	Terms of Modification: Combination of Rate and Maturity	Terms of Modification: Other
Troubled debt restructurings:							
Real estate:							
Residential	1	$ 104	$ 104	$ -	$ 104	$ -	$ -
Commercial	4	1,716	1,737	1,487	-	250	-
Commercial	1	47	47	-	-	-	47
	6	$ 1,867	$ 1,888	$ 1,487	$ 104	$ 250	$ 47

	2012 Number of Contracts	2012 Recorded Investment
Troubled debt restructurings that subsequently defaulted:		
Troubled debt restructurings:		
Real estate:		
Commercial	1	$ 64
	1	$ 64

At December 31, 2013 and 2012, there were $49,000 and $151,000, respectively, in future loan commitments to one borrower classified as a TDR Loan.

During 2013, TDRs that subsequently defaulted had the following adjustments: one loan totaling $104,000 was transferred to OREO and two relationships incurred charge-offs totaling $443,000. The TDR loan that subsequently defaulted in 2012 has been charged-off. TDRs are individually evaluated for impairment. A specific allowance of $1,832,000 and $6,000 was established for the years ended December 31, 2013 and 2012, respectively.

NOTE 5 ALLOWANCE FOR LOAN LOSSES

The following table summarizes the allowance for loan losses by category of loans for the years ended December 31:

($000 Omitted)

	Real Estate									
	Residential	Commercial*	Construction*	Hospitality and Campground	Restaurants	Commercial*	Consumer	Municipal	Unallocated	Total
December 31, 2013										
Allowance for loans losses:										
Beginning balance	$ 854	$ 1,542	$ 560	$ 2,885	$ 68	$ 3,058	$ 444	$ 222	$ 379	$ 10,012
Charge-offs	(184)	(30)	-	(621)	(32)	(515)	(470)	-	-	(1,852)
Recoveries	26	20	12	-	1	18	133	-	-	210
Provision (benefit)	118	355	82	(708)	82	2,502	399	(88)	78	2,820
Ending balance	$ 814	$ 1,887	$ 654	$ 1,556	$ 119	$ 5,063	$ 506	$ 134	$ 457	$ 11,190
Ending balance: individually evaluated for impairment	$ 4	$ 10	$ 160	$ 444	$ -	$ 1,608	$ -	$ -	$ -	$ 2,226
Ending balance: collectively evaluated for impairment	$ 810	$ 1,877	$ 494	$ 1,112	$ 119	$ 3,455	$ 506	$ 134	$ 457	$ 8,964
Loans:										
Ending balance	$ 140,951	$ 180,111	$ 41,865	$ 70,571	$ 10,543	$ 107,674	$ 52,268	$ 38,403	$ -	$ 642,386
Ending balance: individually evaluated for impairment	$ 577	$ 1,108	$ 1,333	$ 4,367	$ -	$ 3,635	$ -	$ -	$ -	$ 11,020
Ending balance: collectively evaluated for impairment	$ 140,374	$ 179,003	$ 40,532	$ 66,204	$ 10,543	$ 104,039	$ 52,268	$ 38,403	$ -	$ 631,366
December 31, 2012										
Allowance for loans losses:										
Beginning balance	$ 917	$ 1,504	$ 597	$ 3,672	$ 177	$ 2,487	$ 514	$ 242	$ 222	$ 10,332
Charge-offs	(185)	(240)	(72)	(109)	(9)	(1,695)	(667)	-	-	(2,977)
Recoveries	2	90	14	-	8	275	156	-	-	545
Provision (benefit)	120	188	21	(678)	(108)	1,991	441	(20)	157	2,112
Ending balance	$ 854	$ 1,542	$ 560	$ 2,885	$ 68	$ 3,058	$ 444	$ 222	$ 379	$ 10,012
Ending balance: individually evaluated for impairment	$ 13	$ 22	$ -	$ 825	$ -	$ 443	$ -	$ -	$ -	$ 1,303
Ending balance: collectively evaluated for impairment	$ 841	$ 1,520	$ 560	$ 2,060	$ 68	$ 2,615	$ 444	$ 222	$ 379	$ 8,709
Loans:										
Ending balance	$ 131,145	$ 124,436	$ 34,749	$ 81,068	$ 7,983	$ 99,377	$ 51,886	$ 42,864	$ -	$ 573,508
Ending balance: individually evaluated for impairment	$ 884	$ 1,731	$ -	$ 13,641	$ 457	$ 2,215	$ -	$ -	$ -	$ 18,928
Ending balance: collectively evaluated for impairment	$ 130,261	$ 122,705	$ 34,749	$ 67,427	$ 7,526	$ 97,162	$ 51,886	$ 42,864	$ -	$ 554,580

*Net of hospitality and campgrounds and restaurants, which are shown separately as they have higher qualitative factors due to the level of concentration and possible credit risk.

The Company utilizes a ten grade internal loan rating system for commercial real estate, commercial construction and commercial loans as follows:

- Loans rated 1-6: Loans in these categories are considered "pass" rated loans with low to average risk.
- Loans rated 7: Loans in this category are considered "special mention." These loans are starting to show signs of potential weakness and are being closely monitored by management.
- Loans rated 8: Loans in this category are considered "substandard." Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.
- Loans rated 9: Loans in this category are considered "doubtful." Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.
- Loans rated 10: Loans in this category are considered uncollectible ("loss") and of such little value that their continuance as loans is not warranted.

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial real estate, commercial construction and commercial relationships over $100,000. Annually, the Company engages an independent third-party loan review consulting firm to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its annual review process.

NOTE 5 ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The credit risk profile of the loan portfolio is as follows for the years ended December 31:

($000 Omitted)

	Real Estate								
	Residential	Commercial *	Construction *	Hospitality and Campground	Restaurant	Commercial *	Consumer	Municipal	Total
December 31, 2013									
Grade:									
Pass	$ 135,755	$ 169,531	$ 40,736	$ 60,050	$ 10,336	$ 90,010	$ 274	$ 834	$ 507,526
Special mention	955	5,089	605	4,567	84	4,374	270	-	15,944
Substandard	1,430	3,894	410	5,685	-	9,381	216	-	21,016
Doubtful	-	-	-	-	-	881	52	-	933
Loss	-	-	-	-	-	-	-	-	-
Loans not formally rated	2,811	1,597	114	269	123	3,028	51,456	37,569	96,967
Total	$ 140,951	$ 180,111	$ 41,865	$ 70,571	$ 10,543	$ 107,674	$ 52,268	$ 38,403	$ 642,386
December 31, 2012									
Grade:									
Pass	$ -	$ 110,972	$ 31,566	$ 58,218	$ 7,066	$ 75,574	$ -	$ -	$ 283,396
Special mention	1,007	7,208	296	7,179	-	3,262	299	-	19,251
Substandard	1,946	1,327	-	15,250	461	2,563	101	-	21,648
Doubtful	-	4	-	-	-	624	54	-	682
Loss	-	-	-	-	-	-	-	-	-
Loans not formally rated	128,192	4,925	2,887	421	456	17,354	51,432	42,864	248,531
Total	$ 131,145	$ 124,436	$ 34,749	$ 81,068	$ 7,983	$ 99,377	$ 51,886	$ 42,864	$ 573,508

*Net of hospitality and campgrounds and restaurants, which are shown separately as they have higher qualitative factors due to the level of concentration and possible credit risk.

NOTE 6 PREMISES AND EQUIPMENT

A summary of premises and equipment follows:

	($000 Omitted) December 31,	
	2013	2012
Land	$ 5,036	$ 3,176
Buildings	12,133	11,202
Leasehold improvements	1,119	799
Equipment	7,005	6,623
Premises and equipment in process	82	2,269
	25,375	24,069
Less accumulated depreciation and amortization	11,240	11,018
	$ 14,135	$ 13,051

Depreciation expense for the years ended December 31, 2013 and 2012 amounted to $1,031,000 and $1,038,000, respectively.

The Company leases four of its banking center locations, two loan production offices, and one parking lot under non-cancellable operating leases. In addition, the Company leases one of its banking center locations under a cancellable operating lease. Minimum lease payments in future periods under non-cancellable operating leases at December 31, 2013 are as follows:

	($000 Omitted)
2014	$ 379
2015	341
2016	243
2017	224
2018	226
Thereafter	581
	$ 1,994

NOTE 6 PREMISES AND EQUIPMENT (CONTINUED)

The terms of four of the leases provide that the Company can, at the end of the current ten-year term, renew three of the leases under two five-year options and one under three five-year options. The terms of two of the leases provide that the Company can, at the end of the current one-year term, renew one of the leases under two one-year options and one under a one-year option. One of these leases provides that the Company can, with no less than 180 days written notice of intention to do so, cancel or opt out of the lease. Five leases contain a provision that the Company shall pay its pro-rata share of operating costs, which may include real estate taxes.

Rent expense for the years ended December 31, 2013 and 2012 amounted to $413,000 and $340,000, respectively.

NOTE 7 OTHER REAL ESTATE OWNED

Other real estate owned consists of real estate acquired by foreclosure or a similar conveyance of title as well as former banking premises for which banking use is no longer contemplated. At December 31, 2013, other real estate owned of $1,581,000 was comprised of commercial real estate of $687,000, former banking premises of $545,000 and residential real estate of $349,000. At December 31, 2012, other real estate owned of $1,126,000 was comprised of commercial real estate of $397,000, former banking premises of $257,000 and residential real estate of $472,000.

Sales of other real estate owned by the Company resulted in gains of $140,000 and $64,000 for the years ended December 31, 2013 and 2012, respectively.

Write-downs of other real estate owned by the Company were $46,000 and $108,000 for the years ended December 31, 2013 and 2012, respectively.

NOTE 8 DEPOSITS

The aggregate amount of maturities for time deposits as of December 31, 2013 for each of the following five years, and thereafter, is as follows:

	($000 Omitted)
2014	$ 103,820
2015	30,433
2016	32,181
2017	22,486
2018	14,477
Thereafter	97
	$ 203,494

At December 31, 2013 and 2012, brokered certificates of deposit of $993,000 and $987,000, respectively, are included in certificate of deposit accounts in denominations of $100,000 or more disclosed on the balance sheet. At December 31, 2013, deposits acquired through a deposit listing service totaling $30,390,000 are included in certificate of deposit accounts in denominations of $100,000 or more disclosed on the balance sheet.

Deposits from related parties held by the Bank at December 31, 2013 and 2012 amounted to $3,222,000 and $2,729,000, respectively.

NOTE 9 SHORT-TERM BORROWINGS

Short-term borrowings at December 31, 2013 and 2012 consisted of securities sold under agreements to repurchase of $35,465,000 and $30,270,000, respectively. Securities sold under agreements to repurchase were at a weighted average rate of 0.14% at December 31, 2013. The securities sold under agreements to repurchase as of December 31, 2013 and 2012 are securities sold on a short-term basis by the Company that have been accounted for not as sales but as borrowings. The underlying securities associated with securities sold under agreements to repurchase are under the control of the Company. The purchasers have agreed to sell to the Company substantially identical securities at the maturity of the agreements.

NOTE 10 LONG-TERM DEBT

Long-term debt at December 31, 2013 and 2012 consisted of FHLBB advances of $60,176,000 and $67,036,000, respectively, as well as $20,620,000 of junior subordinated debentures, for each year.

As of December 31, 2013, contractual principal payments due under long-term debt, which consists of FHLBB advances and junior subordinated debentures, are as follows:

	($000 Omitted)
2014	$ 7,981
2015	9,881
2016	2,000
2017	32,814
2018	-
2019 and years thereafter	28,120
	$ 80,796

The FHLBB long-term debt consisted of fourteen separate advances. Six of these advances, totaling $30,000,000, are callable with the following rates and terms:

($000 Omitted) Amount	Rate	Maturity Date	Next Call Date
$ 3,000	4.29%	07/20/2017	01/21/14 and quarterly thereafter
5,000	4.25%	07/27/2017	01/27/14 and quarterly thereafter
5,000	4.05%	08/02/2017	02/03/14 and quarterly thereafter
2,000	3.99%	08/16/2017	02/18/14 and quarterly thereafter
10,000	4.09%	03/16/2017	03/17/14 and quarterly thereafter
5,000	4.29%	03/23/2017	03/24/14 and quarterly thereafter

The remaining eight advances, totaling $30,176,000, are at effective rates ranging from 1.35% to 2.80% with a weighted average rate of 1.97%.

The $20,620,000 of junior subordinated debentures consists of two issuances described in detail below.

On March 22, 2007, the Company completed the private placement of $10,310,000 aggregate liquidation amount of floating rate trust-preferred securities (the “Trust III Capital Securities”) issued by Northway Capital Trust III (“Capital Trust III”). The Trust III Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust III Capital Securities, which included the proceeds from the sale by Capital Trust III of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the “Trust III Junior Subordinated Debt”), which were issued pursuant to an Indenture, dated March 22, 2007 between the Company and Wilmington Trust Company as Trustee. Both the Trust III Capital Securities and the Trust III Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.60%. Currently, the interest rate on these securities is 1.843%. Payments of distributions and other amounts due on the Trust III Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust III has funds available for the payments of such distributions, pursuant to a Guarantee Agreement, dated March 22, 2007, between the Company and Wilmington Trust Company, as Guarantee Trustee. The Trust III Junior Subordinated Debt and the Trust III Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on March 15, 2012.

NOTE 10 LONG-TERM DEBT (CONTINUED)

On June 15, 2007, the Company completed the private placement of $10,310,000 aggregate liquidation amount of floating rate trust-preferred securities (the "Trust IV Capital Securities") issued by Northway Capital IV ("Capital Trust IV"). The Trust IV Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust IV Capital Securities, which included the proceeds from the sale by the Capital Trust IV of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the "Trust IV Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated June 15, 2007 between the Company and Wells Fargo Bank, National Association as Trustee. Both the Trust IV Capital Securities and the Trust IV Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.49%. Currently, the interest rate on these securities is 1.733%. Payments of distributions and other amounts due on the Trust IV Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust IV has funds available from the payments of such distributions, pursuant to a Guarantee Agreement, dated June 15, 2007, between the Company and Wells Fargo Bank, National Association, as Guarantee Trustee. The Trust IV Junior Subordinated Debt and the Trust IV Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on June 15, 2012.

NOTE 11 GOODWILL AND OTHER INTANGIBLE ASSETS

At December 31, 2013, the Company has goodwill and core deposit intangibles totaling $10,201,000. Core deposit intangibles are being amortized over their estimated useful lives, and both core deposit intangibles and goodwill are tested for impairment at least annually.

The changes in the carrying amount of goodwill and core deposit intangibles for the years ended December 31, 2013 and 2012 are as follows:

	($000 Ommitted)	
	Goodwill	Core Deposit Intangibles
Balance, December 31, 2011	$ 9,934	$ 449
Amortization expense	-	(97)
Balance, December 31, 2012	9,934	352
Amortization expense	-	(85)
Balance, December 31, 2013	$ 9,934	$ 267

Estimated annual amortization expense:	
2014	$ 73
2015	62
2016	50
2017	38
2018	26
2018 and thereafter	18

The following table reflects the gross carrying amount and accumulated amortization of core deposit intangibles as of December 31, 2013:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core deposit intangibles	$ 3,927	$ 3,660	$ 267

Management reviews the carrying amount of intangible assets on an ongoing basis, taking into consideration any events and circumstances that may indicate the carrying value may not be recoverable. During 2013 and 2012, the Company reviewed the carrying amount of intangible assets and determined that no impairment write-down was required.

NOTE 12 REGULATORY MATTERS

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2013, the most recent notification from the FDIC categorized the Bank as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well-capitalized," the Bank must maintain total risk-based, Tier 1 risk-based and Tier 1 leverage ratios above regulatory prescribed minimum levels. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes, as of December 31, 2013 and 2012, that the Company and the Bank met all capital adequacy requirements to which they are subject.

These minimum capital amounts and ratios, as well as the Company's and Bank's actual capital amounts and ratios, are presented in the following table:

($000 Omitted)

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2013						
Tier 1 capital (to average assets)						
Northway Financial, Inc.	$ 96,407	10.73 %	$ 35,930	≥ 4.00 %	N/A	
Northway Bank	82,678	9.25	35,766	≥ 4.00	$ 44,708	≥ 5.00 %
Total capital (to risk-weighted assets)						
Northway Financial, Inc.	104,578	17.20	48,651	≥ 8.00	N/A	
Northway Bank	90,796	15.04	48,308	≥ 8.00	60,385	≥ 10.00
Tier 1 capital (to risk-weighted assets)						
Northway Financial, Inc.	96,407	15.85	24,326	≥ 4.00	N/A	
Northway Bank	82,678	13.69	24,154	≥ 4.00	36,231	≥ 6.00
As of December 31, 2012						
Tier 1 capital (to average assets)						
Northway Financial, Inc.	$ 91,087	10.68 %	$ 34,111	≥ 4.00 %	N/A	
Northway Bank	78,170	9.21	33,961	≥ 4.00	$ 42,451	≥ 5.00 %
Total capital (to risk-weighted assets)						
Northway Financial, Inc.	98,098	18.05	43,486	≥ 8.00	N/A	
Northway Bank	85,134	15.77	43,177	≥ 8.00	53,972	≥ 10.00
Tier 1 capital (to risk-weighted assets)						
Northway Financial, Inc.	91,087	16.76	21,743	≥ 4.00	N/A	
Northway Bank	78,170	14.48	21,589	≥ 4.00	32,383	≥ 6.00

Federal regulations prohibit banking companies from paying dividends on their stock if the effect would cause stockholders' equity to be reduced below applicable regulatory capital requirements or if such declaration and payment would otherwise violate regulatory requirements.

As of December 31, 2013, the Bank is restricted from declaring dividends to Northway in an amount greater than approximately $42,488,000, as such declaration would decrease capital below the Bank's required minimum level of regulatory capital.

NOTE 12 REGULATORY MATTERS (CONTINUED)

On July 9, 2013, Federal Regulators released the Regulatory Capital Interim Final Rule of Basel III with an implementation date of January 1, 2015, with some items phasing in over a period of time. Management is presently reviewing the effect implementation of this rule will have on risk-weighted assets and capital, but does not anticipate any material changes to the capital positions of the Company or the Bank.

NOTE 13 OTHER NONINTEREST EXPENSE

The following table sets forth information relating to the Company's other noninterest expense for the years ended December 31:

	($000 Omitted) 2013	2012
Professional fees	$ 1,417	$ 1,280
Marketing	1,190	1,488
Software expenses	989	946
FDIC insurance	674	689
ATM & debit card expenses	567	538
Telecommunications	497	636
Other	2,898	2,964
	$ 8,232	$ 8,541

NOTE 14 FEDERAL AND STATE TAXES

The components of federal and state tax expense (benefit) for the years ended December 31, are as follows:

	($000 Omitted) 2013	2012
Current		
Federal	$ 1,458	$ (37)
State	-	(53)
	1,458	(90)
Deferred		
Federal	633	1,556
State	417	279
	1,050	1,835
Total	$ 2,508	$ 1,745

NOTE 14 FEDERAL AND STATE TAXES (CONTINUED)

The temporary differences (the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases) that give rise to significant portions of the net deferred income tax asset at December 31, are as follows:

	($000 Omitted) 2013	2012
Deferred income tax assets		
Allowance for loan losses	$ 4,471	$ 3,991
Interest on nonaccrual loans	602	603
Interest on nonaccrual debt securities	-	80
Net unrealized holding loss on securities available-for-sale	1,349	-
Pension unfunded status valuation adjustment	1,574	2,048
Securities write-down	-	885
OREO write-down	134	116
Supplemental pension	743	671
Contribution carry-forward	93	93
New Hampshire Business Enterprise Tax credit carry-forward	298	447
Other	10	9
	9,274	8,943
Deferred income tax liabilities		
Depreciation	(839)	(771)
Amortization of goodwill and core deposit intangible	(2,626)	(2,314)
Prepaid pension	(1,167)	(1,187)
Net unrealized holding gain on securities available-for-sale	-	(1,685)
Net unrealized holding gain on limited partnership	(23)	(38)
Mortgage servicing rights	(613)	(467)
	(5,268)	(6,462)
Deferred income tax asset, net	$ 4,006	$ 2,481

The primary sources of recovery of the deferred income tax asset are taxes paid that are available for carryback and the expectation that the deductible temporary differences will reverse during periods in which the Company generates taxable income.

Total income tax expense for the years ended December 31, 2013 and 2012 differs from the "expected" federal income tax expense at the 34% statutory rate for the following reasons:

	2013	2012
Expected federal income taxes	34.0 %	34.0 %
Interest on municipal securities available-for-sale and municipal loans	(9.7)	(13.4)
State expense, net of federal expense	2.8	1.8
Other	(1.3)	(1.2)
Effective tax rate	25.8 %	21.2 %

It is the Company's policy to provide for uncertain tax positions and the related interest and penalties based upon management's assessment of whether a tax benefit is more likely than not to be sustained upon examination by tax authorities. As of December 31, 2013 and 2012, there were no material uncertain tax positions related to federal and state tax matters. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service and state taxing authorities for the years ended December 31, 2010 through December 31, 2013.

NOTE 15 EMPLOYEE BENEFITS

Pension Plan

The Company maintains a trusteed non-contributory pension plan (the "Plan") covering substantially all full-time employees. Assuming retirement at age 65 after 30 years or more of service, the benefits are computed as the sum of one percent of final average earnings up to a covered compensation limit, plus 0.65 percent of final average earnings in excess of covered compensation, times years of service, up to 30. Final average earnings are defined as the five consecutive years out of the employee's last ten years of employment during which compensation is highest. The amounts contributed to the Plan are determined annually on the basis of (a) the maximum amount that can be deducted for federal income tax purposes or (b) the amount certified by a consulting actuary as necessary to avoid an accumulated funding deficiency as defined by the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only benefits attributed to service to date but also for those expected to be earned in the future.

The following table sets forth information about the Plan as of December 31, 2013 and 2012 and for the years then ended:

	($000 Omitted)	
	2013	2012
Obligations and funded status		
Change in benefit obligation		
Projected benefit obligation at beginning of year	$ 14,971	$ 13,223
Service cost	946	731
Interest cost	664	591
Actuarial (gain)/loss	(1,031)	740
Benefits paid	(378)	(314)
Projected benefit obligation at end of year	15,172	14,971
Change in plan assets		
Fair value of plan assets at beginning of year	12,802	10,570
Actual return on plan assets	723	1,245
Employer contributions	1,000	1,300
Benefits paid	(378)	(313)
Fair value of plan assets at end of year	14,147	12,802
Funded status at end of year	$ (1,025)	$ (2,169)
Amounts recognized in accumulated other comprehensive loss consist of:		
Unrecognized prior service credit	$ (116)	$ (199)
Unrecognized net loss	4,088	5,366
Total	$ 3,972	$ 5,167
Accumulated benefit obligation	$ 13,096	$ 12,985

NOTE 15 EMPLOYEE BENEFITS (CONTINUED)

	($000 Omitted) 2013	2012
Net periodic pension cost		
Service cost	$ 946	$ 731
Interest cost	664	590
Expected return on plan assets	(817)	(696)
Amortization of prior service credit	(83)	(85)
Amortization of net actuarial loss	341	310
Net periodic pension cost	1,051	850
Other changes in plan assets and benefit obligations recognized in other comprehensive loss		
Net actuarial (gain)/loss for period	(937)	191
Amortization of prior service credit	83	85
Amortization of net actuarial loss	(341)	(310)
Total	(1,195)	(34)
Total recognized in net periodic pension cost and other comprehensive (income) loss	$ (144)	$ 816
Estimated amortization from the accumulated other comprehensive loss into net periodic pension cost over the next fiscal year		
Amortization of net loss	$ 189	$ 281
Amortization of prior service credit	(85)	(85)

	2013	2012
Weighted-average assumptions used to determine pension obligations at measurement date		
Discount rate	5.00 %	4.25 %
Rate of compensation increase	2.75	2.75
Weighted-average assumptions used to determine net periodic pension cost for the years ended December 31,		
Discount rate	4.25 %	4.50 %
Expected long-term rate of return on plan assets	6.50	6.50
Rate of compensation increase	2.75	2.75

The expected long-term rate of return for the Plan's total assets is based on the expected return of asset categories identified below, weighted based on the target allocations for each class. Equity funds are expected to return 8% to 10% over the long-term and bond funds and short-term money markets are expected to return between 4% and 6%.

The Company's pension plan actual asset allocations by asset category are as follows:

	Percentage of Plan Assets at December 31:	
	2013	2012
Asset category		
Mutual funds:		
Bond funds	65.0 %	65.0 %
Equity funds	25.0	25.0
Real estate funds	10.0	10.0
Total	100.0 %	100.0 %

The Company's pension plan assets are generally classified within level 2 of the fair value hierarchy (See NOTE 18, "Fair Value Measurements," to the Consolidated Financial Statements for a description of the fair value hierarchy) because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of transparency.

The fair values of the Company's pension plan assets at December 31, 2013 and 2012 by asset category, are as follows:

Category	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Other Observable Inputs Level 3
	($000 Omitted) Fair Value Measurements at Reporting Date Using:			
December 31, 2013				
Common/collective trust funds				
Corporate bond funds	$ 7,836	$ -	$ 7,836	$ -
Inflation-protected bond fund	636	-	636	-
Large growth	1,067	-	1,067	-
Large value	1,067	-	1,067	-
Mid-cap growth	320	-	320	-
Mid-cap value	320	-	320	-
Small-cap growth	638	-	638	-
International	853	-	853	-
Real estate	1,410	-	1,410	-
Totals	$ 14,147	$ -	$ 14,147	$ -
December 31, 2012				
Common/collective trust funds				
Corporate bond funds	$ 7,147	$ -	$ 7,147	$ -
Inflation-protected bond fund	563	-	563	-
Large growth	929	-	929	-
Large value	962	-	962	-
Mid-cap growth	283	-	283	-
Mid-cap value	293	-	293	-
Small-cap growth	577	-	577	-
International	764	-	764	-
Real estate	1,284	-	1,284	-
Totals	$ 12,802	$ -	$ 12,802	$ -

The investment policy, as established by the Company, is to provide for a moderate growth of capital with a moderate level of volatility by investing assets per the target allocations as follows:

Asset category	2013	2012
Mutual funds:		
Bond funds	65%	65%
Equity funds	25	25
Real estate funds	10	10
Other	0-5	0-5

The assets will be re-allocated quarterly to meet the above target allocations. The investment policy is reviewed on an annual basis, under the advisement of the Company's certified investment advisor, to determine if the policy should be changed.

The plan assets do not include any Northway common stock at December 31, 2013 and 2012.

The Company expects to contribute $800,000 to the Plan in 2014.

Estimated future benefit payments, which reflect future service, as appropriate, are as follows for the years ended December 31:

	($000 Omitted)
2014	$ 486
2015	507
2016	541
2017	590
2018	657
2019-2023	4,174

401(k) Plan

The Company offers a contributory 401(k) Plan. Under the Northway Financial, Inc. 401(k) and Profit Sharing Plan (the "401(k) Plan"), employees are eligible to participate after attaining age 21, completing six months of service and have been credited with 1,000 hours of service. Under the 401(k) Plan, the Company matches 50 percent of the first 4 percent of employee contributions. Total 401(k) Plan matching expense in 2013 and 2012 amounted to $178,000 and $166,000, respectively, and there was no Profit Sharing contribution expense for each of the years ended December 31, 2013 and 2012.

Supplemental Executive Retirement Plan (SERP)

Effective May 29, 2003, the existing Executive Life program sponsored by the Company was terminated and replaced with a Supplemental Executive Retirement Plan (SERP) in which the Chief Executive Officer ("CEO") participates. The existing life insurance policy designed to support the Executive Life program is now fully owned by Northway. This policy is maintained by Northway and is used as the benchmark for the SERP.

The SERP consists of two components. The first component is a distribution of the account balance in equal installments over the ten years following the CEO's retirement without interest. This account balance reflects the cumulative net appreciation in a life insurance policy with a gross-up to reflect the Company's tax savings. The net appreciation is the gain in the surrender value of the life insurance policy less the cost of the premiums and benefit payments. The cost of premiums and benefits for 2013 was 0.7%. The account balance at the November 19, 2013 plan year end was $784,014. If the CEO dies before the end of the ten year period, his beneficiary receives the unpaid portion in a lump sum. The second component is a lifetime distribution beginning in the second year following retirement equal to the annual net appreciation in the life insurance policy with a gross-up to reflect the Company's tax savings. As of December 31, 2013 and 2012, the Company has accrued a liability related to the SERP in the amount of $2,091,000 and $1,874,000, respectively. The respective liabilities reflect the present value of all expected postretirement benefits. In the event of the CEO's death while employed by the Company, the SERP permits a death benefit of $2,000,000 be paid to his beneficiary.

NOTE 15 EMPLOYEE BENEFITS (CONTINUED)

Change in Control

The Company has entered into agreements with certain executive officers as well as other senior officers of the Company. These agreements provide for payments, under certain circumstances, to the officer upon the officer's termination after a change in control. Payments will be made under these agreements upon the officer's termination or resignation in connection with certain specified actions adverse to the officer's employment status after a change in control. The amount of such payments ranges from 1.0 to 2.99 times such officer's annual compensation.

NOTE 16 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to originate loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with off-balance sheet credit risk at December 31, are as follows:

	($000 Omitted) 2013	2012
Financial instruments whose contract amounts represent credit risk:		
Unadvanced portion of home equity loans	$ 22,593	$ 20,887
Unadvanced portions of lines of credit	69,305	46,949
Unadvanced portions of commercial real estate loans	34,776	24,057
Commitments to originate residential real estate loans for resale	2,604	14,332
Commitments to originate municipal loans	3,000	230
Commitments to originate all other loans	13,077	48,587
Unadvanced portions of Bounce Protection ™	15,345	15,224
Standby letters of credit	2,446	271
Total	$ 163,146	$ 170,537

Commitments to originate loans, residential real estate loans for resale and municipal loans, unadvanced portions of home equity loans, lines of credit and commercial real estate loans are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without having been drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower.

Unadvanced portions of Bounce Protection™ represent the unused portion of the Bank's overdraft privilege program.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers. As of December 31, 2013 and 2012, the maximum potential amount of the Company's obligation was $2,446,000 and $271,000, respectively, for financial and standby letters of credit. The Company's outstanding letters of credit generally have a term of less than one year. If a letter of credit is drawn upon, the Company may seek recourse through the customer's underlying line of credit. If the customer's line of credit is also in default, the Company may take possession of the collateral, if any, securing the line of credit.

NOTE 17 ON-BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Risk Management Policies – Hedging Instruments
The primary focus of the Company's asset/liability management program is to monitor the sensitivity of the Company's net portfolio value and net income under varying interest rate scenarios to take steps to control its risks if the risk is deemed probable. On a quarterly basis, the Company simulates the net portfolio value and net income expected to be earned over a twelve-month period following the date of simulation. The simulation is based on projection of market interest rates at varying levels and estimates the impact this level of market rates would have on the pricing for current and future interest-earning assets and interest-bearing liabilities during the measurement period. Based on the outcome of the simulation analysis, the Company considers the use of derivatives as a means of reducing the volatility of net portfolio value and projected net income within certain ranges of projected changes in interest rates. The Company evaluates the effectiveness of entering into any derivative instrument agreement by measuring the cost of such an agreement in relation to the reduction in net portfolio value and net income volatility within an assumed range of interest rates.

Interest Rate Risk Management – Cash Flow Hedging Instruments
The Company uses long-term variable-rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments. To meet this objective, management enters into interest rate swap agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

Interest Rate Risk Management – Derivative Instruments Not Designated As Hedging Instruments
The Company enters into rate lock commitments to extend credit to borrowers for generally a 30-day or 60-day period for the origination and/or purchase of loans. Unfunded loans for which commitments have been entered into are called "pipeline loans." Some of these rate lock commitments will ultimately expire without being completed. To the extent that a loan is ultimately granted and the borrower ultimately accepts the terms of the loan, these rate lock commitments expose the Company to variability in their fair value due to changes in interest rates. If interest rates increase, the value of these rate lock commitments decreases. Conversely, if interest rates decrease, the value of these rate lock commitments increases.

Loan commitments related to the origination or acquisition of mortgage loans that will be held for sale are accounted for as derivative instruments. Such commitments, along with any related fees received from potential borrowers, are recorded at fair value in derivative assets or liabilities, with changes in fair value recorded in the net gain or loss on sale of mortgage loans. Fair value is based on fees currently charged to enter into similar agreements, and for fixed-rate commitments, also considers the difference between current levels of interest rates and the committed rates.

There were no derivatives held during 2013, nor outstanding as of December 31, 2013.

Collateral Requirements
To reduce the risk related to the use of both derivatives and credit-related financial instruments, the Company might deem it necessary to obtain collateral. The amount and nature of the collateral obtained is based on the Company's credit evaluation of the customer. Collateral held varies but may include cash, securities, accounts receivable, inventory, property, plant and equipment and real estate.

If the counterparty does not have the right and ability to redeem the collateral or the Company is permitted to sell or re-pledge the collateral on short notice, the Company records the collateral in its balance sheet at fair value with a corresponding obligation to return it.

NOTE 18 FAIR VALUE MEASUREMENTS

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents approximates the fair value of those assets.

Interest-bearing time deposits with other banks: The fair values of interest-bearing time deposits with other banks are estimated using discounted cash flow analyses using interest rates currently being offered for deposits with similar terms to investors.

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

Securities: Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

FHLBB stock: The carrying amount reported in the consolidated balance sheets for FHLBB stock approximates its fair value. If redeemed, the Company will receive an amount equal to the par value of the stock.

Loans held-for-sale: Fair values for loans held-for-sale are estimated based on outstanding investor commitments, or in the absence of such commitments, are based on current investor yield requirements.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The fair values of nonaccrual loans are estimated using discounted cash flow analyses or the estimated fair value of the underlying collateral where applicable.

Accrued interest receivable: The carrying value of accrued interest receivable approximates its fair value because of the short-term nature of this financial instrument.

Deposits: The fair value of demand deposits (e.g. Demand, regular savings, NOW and money market deposit accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). Fair values for time deposits are estimated using a discounted cash flow technique that applies interest rates currently being offered on such deposits to a schedule of aggregated expected monthly maturities of time deposits.

Short-term borrowings: The carrying value of short-term borrowings approximates its fair value because of the short-term nature of these financial instruments.

Long-term debt: The fair values of long-term debt are determined by discounting the anticipated future cash payments by using the rates currently available to the Company for debt with similar terms and remaining maturities.

Junior subordinated debentures: The fair values of junior subordinated debentures are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or by discounting the anticipated future cash payments by using the rate currently available to the Company for debt with similar terms and remaining maturities.

Off-balance sheet instruments: The fair value of commitments to originate loans is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments and the unadvanced portion of loans, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligation with the counterparties at the reporting date. See NOTE 16 for further information.

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

The estimated fair values of the Company's financial instruments are as follows:

	($000 Omitted) December 31, 2013				
	Carrying Amount	Fair Value			
		Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and cash equivalents	$ 29,423	$ 29,423	$ -	$ -	$ 29,423
Interest-bearing time deposits with other banks	3,968	-	3,980	-	3,980
Securities available-for-sale	184,527	11,080	173,447	-	184,527
FHLBB stock	5,045	5,045	-	-	5,045
Loans held-for-sale	1,595	-	1,623	-	1,623
Loans, net	631,069	-	-	628,147	628,147
Accrued interest receivable	2,702	2,702	-	-	2,702
Financial liabilities:					
Deposits	694,359	490,865	205,747	-	696,612
Short-term borrowings	35,465	35,465	-	-	35,465
Long-term debt	60,176	-	64,317	-	64,317
Junior subordinated debentures	20,620	-	19,183	-	19,183

	($000 Omitted) December 31, 2012				
	Carrying Amount	Fair Value			
		Level 1	Level 2	Level 3	Total
Financial assets:					
Cash and cash equivalents	$ 49,976	$ 49,976	$ -	$ -	$ 49,976
Interest-bearing time deposits with other banks	4,712	-	4,755	-	4,755
Securities available-for-sale	206,703	10,520	195,270	913	206,703
FHLBB stock	5,176	5,176	-	-	5,176
Loans held-for-sale	3,656	-	3,720	-	3,720
Loans, net	563,565	-	-	571,169	571,169
Accrued interest receivable	2,731	2,731	-	-	2,731
Financial liabilities:					
Deposits	668,464	492,835	178,039	-	670,874
Short-term borrowings	30,270	30,270	-	-	30,270
Long-term debt	67,036	-	72,102	-	72,102
Junior subordinated debentures	20,620	-	17,342	-	17,342

The carrying amounts of financial instruments shown in the above table are included in the consolidated balance sheets under the indicated captions except that accrued interest receivable is included with other assets and junior subordinated debentures are included with long-term debt.

At December 31, 2013 and 2012, all the Company's financial instruments were held for purposes other than trading.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for some of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, cash flows, current economic conditions, risk characteristics, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions and changes in the loan, debt and interest rate markets could significantly affect the estimates. Further, the income tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered. The fair value amounts presented do not represent the underlying value of the Company because fair values of certain other financial instruments, assets and liabilities have not been determined.

ASC 820-10, "Fair Value Measurements and Disclosures," provides a framework for measuring fair value under generally accepted accounting principles. This guidance also allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis.

In accordance with ASC 820-10, the Company groups its financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 - Valuations for assets and liabilities that are derived from other methodologies, including option pricing models, discounted cash flow models and similar techniques, are not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets and liabilities.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

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, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value for December 31, 2013 and 2012. The Company did not have any significant transfers of assets between level 1 and level 2 of the fair value hierarchy during the year ended December 31, 2013.

The Company's cash instruments are generally classified within level 1 or level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

The Company's investment in debt and mortgage-backed securities available-for-sale is generally classified within level 2 of the fair value hierarchy. For these securities, fair value measurements are obtained from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trading levels, market consensus prepayment speeds, credit information and the instrument's terms and conditions.

The Company's derivative financial instruments are generally classified within level 2 of the fair value hierarchy. For these financial instruments, the Company obtains fair value measurements from independent pricing services. The fair value measurement utilizes a discounted cash flow model that incorporates and considers observable data, that may include publicly available third party market quotes, in developing the curve utilized for discounting future cash flows.

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the

absence of such evidence, management's best estimate is used. Subsequent to inception, management only changes level 3 inputs and assumptions when corroborated by evidence such as transactions in similar instruments, completed or pending third-party transactions in the underlying investment or comparable entities, subsequent rounds of financing, recapitalization and other transactions across the capital structure, offerings in the equity or debt markets, and changes in financial ratios or cash flows.

The Company's impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using level 2 inputs based upon appraisals of similar properties obtained from a third party. For level 3 inputs, fair value is based upon management estimates of the value of the underlying collateral or the present value of the expected cash flows.

Other real estate owned values are estimated using level 2 inputs based upon appraisals of similar properties obtained from a third party. For level 3 inputs, fair values are based on management estimates.

The following summarizes assets measured at fair value for the periods ending December 31, 2013 and 2012:

ASSETS MEASURED AT FAIR VALUE ON A RECURRING BASIS

	($000 Omitted) Fair Value Measurements at Reporting Date Using:			
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
December 31, 2013				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 18,081	$ -	$ 18,081	$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	93,544	-	93,544	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	3,691	-	3,691	-
State and political subdivision bonds	58,130	-	58,130	-
Collateralized mortgage obligations issued by others	1	-	1	-
Marketable equity securities	11,080	11,080	-	-
Total	$ 184,527	$ 11,080	$ 173,447	$ -
December 31, 2012				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	$ 10,951	$ -	$ 10,951	$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	115,991	-	115,991	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	6,365	-	6,365	-
State and political subdivision bonds	61,962	-	61,962	-
Collateralized mortgage obligations issued by others	1	-	1	-
Marketable equity securities	10,520	10,520	-	-
Trust-preferred securities	913	-	-	913
Total	$ 206,703	$ 10,520	$ 195,270	$ 913

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

	($000 Omitted) Fair Value Measurements Using Significant Unobservable Inputs Level 3	
	Available-for-Sale Securities	
	2013	2012
Beginning balance	$ 913	$ 616
Total gains or losses (realized/unrealized)		
Included in earnings	79	-
Included in other comprehensive income	-	297
Transfers in and/or out of Level 3	(992)	-
Ending balance	$ -	$ 913
The amount of total gains or losses for the period included	$ 79	$ -

ASSETS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

Under certain circumstances the Company makes adjustments to its assets and liabilities although they are not measured at fair value on an ongoing basis. The following table presents the carrying value of assets reflected in the consolidated balance sheet by caption and by level in the fair value hierarchy at December 31, 2013 and 2012, for which a nonrecurring change in fair value has been recorded.

		($000 Omitted) Fair Value Measurements at Reporting Date Using:		
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
December 31, 2013				
Impaired loans	$ 3,785	$ -	$ -	$ 3,785
OREO	336	-	-	336
Totals	$ 4,121	$ -	$ -	$ 4,121
December 31, 2012				
Impaired loans	$ 2,421	$ -	$ -	$ 2,421
OREO	257	-	-	257
Totals	$ 2,678	$ -	$ -	$ 2,678

NOTE 19 SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 18, 2014, which is the date the consolidated financial statements were available to be issued. There were no subsequent events that require adjustments to or disclosure in the consolidated financial statements.

INDEPENDENT AUDITOR'S REPORT

Shatswell, MacLeod & Company, P.C.
Certified Public Accountants
83 Pine Street
West Peabody, Massachusetts 01960

The Board of Directors and Stockholders
Northway Financial, Inc.
Berlin, New Hampshire

We have audited the accompanying consolidated balance sheets of Northway Financial, Inc. and its Subsidiary as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Northway Financial, Inc. and its Subsidiary as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Shatswell, MacLeod + Company, P.C.

SHATSWELL, MacLEOD & COMPANY, P.C.

West Peabody, Massachusetts
March 18, 2014

SKU # 002CSN35DF