



KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016 and 2015

With Independent Auditor's Report



INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders
Katahdin Bankshares Corp. and Subsidiary

We have audited the accompanying consolidated financial statements of Katahdin Bankshares Corp. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, 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 U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the 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 U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from 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 consolidated financial position of Katahdin Bankshares Corp. and Subsidiary as of December 31, 2016 and 2015, and the consolidated results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Berry Dunn McNeil & Parker, LLC

Bangor, Maine
February 2, 2017

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2016 and 2015

ASSETS

	<u>2016</u>	<u>2015</u>
Cash and due from banks	\$ 6,450,000	\$ 6,388,000
Interest bearing deposits in banks	4,873,000	5,157,000
Securities available-for-sale	87,271,000	72,501,000
Securities held-to-maturity	12,000	16,000
Federal Home Loan Bank stock, at cost	1,682,000	2,319,000
Loans receivable, net of allowance for loan losses of \$6,032,000 in 2016 and \$5,330,000 in 2015	617,247,000	580,908,000
Bank premises and equipment, net	12,162,000	13,172,000
Goodwill	5,559,000	5,559,000
Other assets	<u>18,756,000</u>	<u>16,269,000</u>
	<u>\$754,012,000</u>	<u>\$702,289,000</u>

The accompanying notes are an integral part of these consolidated financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY

	<u>2016</u>	<u>2015</u>
Deposits		
Demand deposits	\$ 102,851,000	\$ 103,491,000
NOW and money market deposits	267,384,000	206,646,000
Savings deposits	58,817,000	53,838,000
Certificates of deposit \$250,000 and over	137,183,000	154,737,000
Other certificates of deposit	<u>86,734,000</u>	<u>87,493,000</u>
Total deposits	652,969,000	606,205,000
Advances from Federal Home Loan Bank	21,178,000	20,188,000
Other borrowed funds	889,000	540,000
Accrued expenses and other liabilities	7,344,000	5,782,000
Junior subordinated debentures	<u>7,217,000</u>	<u>7,217,000</u>
Total liabilities	<u>689,597,000</u>	<u>639,932,000</u>
Shareholders' equity		
Preferred stock, 20,000 shares authorized		
Series D, 4,000 shares issued and outstanding	9,766,000	9,673,000
Common stock, \$.10 par value; 20,000,000 shares authorized, 3,404,367 shares issued and outstanding on December 31, 2016 and 2015	339,000	339,000
Surplus	8,778,000	8,776,000
Undivided profits	46,980,000	44,496,000
Accumulated other comprehensive loss		
Net unrealized depreciation on securities available-for-sale, net of deferred income taxes	(856,000)	(109,000)
Net unrealized loss on derivative instruments, net of deferred income taxes	(319,000)	(818,000)
Unearned ESOP shares	<u>(273,000)</u>	<u>-</u>
Total shareholders' equity	<u>64,415,000</u>	<u>62,357,000</u>
	<u>\$ 754,012,000</u>	<u>\$ 702,289,000</u>

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Consolidated Statements of Income

Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Interest and dividend income		
Loans	\$ 27,558,000	\$ 26,063,000
Investment securities	1,783,000	1,441,000
Other interest-earning assets	<u>9,000</u>	<u>8,000</u>
Total interest and dividend income	<u>29,350,000</u>	<u>27,512,000</u>
Interest expense		
Deposits	3,778,000	3,447,000
Borrowed funds and junior subordinated debentures	<u>503,000</u>	<u>414,000</u>
Total interest expense	<u>4,281,000</u>	<u>3,861,000</u>
Net interest income	25,069,000	23,651,000
Provision for loan losses	<u>1,316,000</u>	<u>50,000</u>
Net interest income after provision for loan losses	<u>23,753,000</u>	<u>23,601,000</u>
Noninterest income		
Service charges and fees	1,862,000	1,839,000
Realized gain on sale of securities available-for-sale	59,000	13,000
Other	<u>2,543,000</u>	<u>2,032,000</u>
Total noninterest income before impairment of investment securities	<u>4,464,000</u>	<u>3,884,000</u>
Total other-than-temporary impairment losses	(16,000)	(13,000)
Portion of loss recognized in other comprehensive income	<u>12,000</u>	<u>11,000</u>
Net impairment losses recognized in net income	<u>(4,000)</u>	<u>(2,000)</u>
Net noninterest income	<u>4,460,000</u>	<u>3,882,000</u>
Noninterest expenses		
Salaries and employee benefits	12,993,000	12,277,000
Net occupancy expense	1,617,000	1,614,000
Furniture and equipment expense	1,796,000	1,746,000
Data processing	1,242,000	1,020,000
Marketing	783,000	838,000
FDIC deposit assessment	561,000	494,000
Other general and administrative	<u>2,543,000</u>	<u>2,383,000</u>
Total noninterest expenses	<u>21,535,000</u>	<u>20,372,000</u>
Income before income taxes	6,678,000	7,111,000
Income tax expense	<u>1,864,000</u>	<u>2,301,000</u>
Net income	<u>\$ 4,814,000</u>	<u>\$ 4,810,000</u>
Less dividends on preferred stock	<u>\$ 875,000</u>	<u>\$ 910,000</u>
Net income available to common shareholders	<u>\$ 3,939,000</u>	<u>\$ 3,900,000</u>
Basic earnings per common share	<u>\$ 1.16</u>	<u>\$ 1.15</u>
Diluted earnings per common share	<u>\$ 1.16</u>	<u>\$ 1.15</u>
Diluted weighted average common shares outstanding	<u>3,399,826</u>	<u>3,404,367</u>

The accompanying notes are an integral part of these consolidated financial statements.

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Net income	<u>\$ 4,814,000</u>	<u>\$ 4,810,000</u>
Other comprehensive loss, net of related tax effects		
Unrealized depreciation on available-for-sale securities		
Unrealized depreciation on available-for-sale securities arising during period	<u>(692,000)</u>	<u>(49,000)</u>
Reclassification adjustment for gains realized in net income	<u>(59,000)</u>	<u>(13,000)</u>
Reclassification adjustment for losses realized in net income	<u>4,000</u>	<u>2,000</u>
Net change in unrealized depreciation on available-for-sale securities	<u>(747,000)</u>	<u>(60,000)</u>
Unrealized gain (loss) on derivative instruments	<u>499,000</u>	<u>(207,000)</u>
Total other comprehensive loss	<u>(248,000)</u>	<u>(267,000)</u>
Comprehensive income	<u>\$ 4,566,000</u>	<u>\$ 4,543,000</u>

The accompanying notes are an integral part of these consolidated financial statements.

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity

Years Ended December 31, 2016 and 2015

	Preferred Stock	Common Stock	Surplus	Undivided Profits	Net Unrealized Depreciation on Securities	Net Unrealized Loss on Derivative Instruments	Unearned ESOP Shares	Total
Balance, December 31, 2014	<u>\$ 20,603,000</u>	<u>\$ 339,000</u>	<u>\$ 8,776,000</u>	<u>\$42,028,000</u>	<u>\$ (49,000)</u>	<u>\$ (611,000)</u>	<u>\$ -</u>	<u>\$ 71,086,000</u>
Net income	-	-	-	4,810,000	-	-	-	4,810,000
Change in net unrealized depreciation on securities available-for-sale, net of deferred income taxes of \$(31,000)	-	-	-	-	(60,000)	-	-	(60,000)
Change in net unrealized loss on derivative instruments, at fair value, net of taxes of \$(107,000)	-	-	-	-	-	(207,000)	-	(207,000)
Total comprehensive income	-	-	-	4,810,000	(60,000)	(207,000)	-	4,543,000
Cash dividends declared on common stock, \$0.40 per share	-	-	-	(1,362,000)	-	-	-	(1,362,000)
Redemption of preferred stock Series C, 11,000 shares	(11,000,000)	-	-	-	-	-	-	(11,000,000)
Accretion on preferred stock issuance	70,000	-	-	(70,000)	-	-	-	-
Cash dividends declared on preferred stock	-	-	-	(910,000)	-	-	-	(910,000)
Balance, December 31, 2015	<u>9,673,000</u>	<u>339,000</u>	<u>8,776,000</u>	<u>44,496,000</u>	<u>(109,000)</u>	<u>(818,000)</u>	<u>-</u>	<u>62,357,000</u>
Net income	-	-	-	4,814,000	-	-	-	4,814,000
Change in net unrealized depreciation on securities available-for-sale, net of deferred income taxes of \$(385,000)	-	-	-	-	(747,000)	-	-	(747,000)
Change in net unrealized loss on derivative instruments, at fair value, net of taxes of \$257,000	-	-	-	-	-	499,000	-	499,000
Total comprehensive income	-	-	-	4,814,000	(747,000)	499,000	-	4,566,000
Cash dividends declared on common stock, \$0.40 per share	-	-	-	(1,362,000)	-	-	-	(1,362,000)
Accretion on preferred stock issuance	93,000	-	-	(93,000)	-	-	-	-
Cash dividends declared on preferred stock	-	-	-	(875,000)	-	-	-	(875,000)
Shares purchased by ESOP (25,500 shares)	-	-	-	-	-	-	(287,000)	(287,000)
Common stock held by ESOP committed to be released (1,306 shares)	-	-	2,000	-	-	-	14,000	16,000
Balance, December 31, 2016	<u>\$ 9,766,000</u>	<u>\$ 339,000</u>	<u>\$ 8,778,000</u>	<u>\$46,980,000</u>	<u>\$ (856,000)</u>	<u>\$ (319,000)</u>	<u>\$ (273,000)</u>	<u>\$ 64,415,000</u>

The accompanying notes are an integral part of these consolidated financial statements.

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Consolidated Statements of Cash Flows

Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash flows from operating activities		
Net income	\$ 4,814,000	\$ 4,810,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,849,000	1,541,000
Net amortization of securities	231,000	169,000
Provision for loan losses	1,316,000	50,000
Provision for losses on other real estate owned	29,000	29,000
Amortization of investments in limited partnerships	69,000	264,000
Impairment of investment securities	4,000	2,000
Gain on sale of securities available-for-sale	(59,000)	(13,000)
Deferred income tax liability (benefit)	514,000	(681,000)
Increase in cash value of life insurance	(309,000)	(270,000)
Loss on sale of other real estate and property owned	41,000	21,000
ESOP compensation expense	16,000	-
Decrease in accrued income receivable and other assets	540,000	212,000
Increase in accrued expenses and other liabilities	227,000	193,000
Net cash provided by operating activities	<u>9,282,000</u>	<u>6,327,000</u>
Cash flows from investing activities		
Additions to premises and equipment	(385,000)	(474,000)
Loan originations and principal collections, net	(38,205,000)	(21,944,000)
Purchase of securities available-for-sale	(28,631,000)	(23,533,000)
Maturities of securities available-for-sale	10,149,000	8,768,000
Maturities of securities held-to-maturity	4,000	4,000
Proceeds from sales of other real estate and property owned	444,000	211,000
Redemption of FHLB stock	1,405,000	-
Purchase of FHLB stock	(768,000)	(415,000)
Proceeds from sale of securities available-for-sale	2,404,000	690,000
Purchase of bank-owned life insurance	(1,500,000)	(1,000,000)
Proceeds from death benefit of bank-owned life insurance	-	191,000
Net cash used by investing activities	<u>(55,083,000)</u>	<u>(37,502,000)</u>
Cash flows from financing activities		
Net increase in deposits	46,764,000	55,511,000
Net increase (decrease) in securities sold under agreements to repurchase	349,000	(471,000)
Net increase in short-term borrowings	21,000,000	13,695,000
Repayment of long-term debt	(20,010,000)	(25,011,000)
Redemption of preferred stock	-	(11,000,000)
Cash dividends paid on preferred stock	(875,000)	(910,000)
Cash dividends paid on common stock	(1,362,000)	(1,362,000)
Cash provided to ESOP for purchase of shares	(287,000)	-
Net cash provided by financing activities	<u>45,579,000</u>	<u>30,452,000</u>
Net decrease in cash and cash equivalents	<u>(222,000)</u>	<u>(723,000)</u>
Cash and cash equivalents, beginning of year	<u>11,545,000</u>	<u>12,268,000</u>
Cash and cash equivalents, end of year	<u>\$ 11,323,000</u>	<u>\$ 11,545,000</u>
Supplementary cash flow information:		
Interest paid on deposits and borrowed funds	\$ 4,255,000	\$ 3,881,000
Income taxes paid	2,041,000	1,703,000
Noncash transactions		
Transfer from loans to other real estate and property owned	550,000	424,000
Preferred stock dividends declared but not paid	219,000	219,000

The accompanying notes are an integral part of these consolidated financial statements.

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Nature of Business

Katahdin Bankshares Corp. (the Company) is a bank holding company. A subsidiary, Katahdin Trust Company (the Bank), is a state-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank's primary business is to loan funds to and accept deposits from consumers and small businesses in Aroostook and Penobscot counties and the Portland area. The Bank has full-service branches throughout Aroostook and northern Penobscot counties, the greater Bangor area of central Maine in Penobscot county and in the Portland metro area of Cumberland county. The Scarborough location also houses Maine Financial Group (MFG), which the Bank purchased in 2007. MFG provides equipment financing for individuals and businesses in the trucking, construction, forest products, and marine industries throughout northern New England. The Company and its subsidiary are subject to regulation and periodic examination by the FDIC, the Maine Bureau of Financial Institutions, and the Federal Reserve System.

1. Summary of Significant Accounting Policies

Basis of Presentation and Consolidation

The consolidated financial statements include the accounts of Katahdin Bankshares Corp. and its wholly-owned subsidiary, Katahdin Trust Company. All significant intercompany balances and transactions have been eliminated in consolidation.

Pursuant to the criteria established by U.S. generally accepted accounting principles (GAAP), the Company has not consolidated the trusts which it formed for the purposes of issuing trust preferred securities to unaffiliated parties and investing the proceeds from the issuance thereof and the common securities of the trust in junior subordinated debentures issued by the Company. The trusts are considered affiliates (see Note 10).

Use of Estimates

In preparing consolidated financial statements in conformity with GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of other real estate and property owned. In connection with the determination of the allowance for loan losses and the carrying value of other real estate and property owned, management obtains independent appraisals for significant properties.

While management uses all available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in the economy. In addition, regulatory agencies, as a part of their examination process, periodically review the Bank's loan portfolio and may require the Bank to make additions to the allowance for loan losses based on judgments about information available to them at the time of the examination. Because of these

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

factors, it is reasonably possible that the allowance for loan losses may change materially in the near term.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks and interest bearing deposits in banks.

The Company's due from bank accounts and interest bearing deposits in banks, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts. The Company believes it is not exposed to any significant risk on cash and cash equivalents.

Securities

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

Purchase premiums and discounts are recognized in interest income using a method approximating the interest method over the terms of the securities. Declines in the fair value of individual equity securities that are deemed to be other-than-temporary are reflected in earnings when identified. For individual debt securities where the Company does not intend to sell the security and it is more-likely-than-not that the Company will not be required to sell the security before recovery of its amortized cost basis, the other-than-temporary decline in the fair value of the debt security related to 1) credit loss is recognized in earnings and 2) other factors are recognized in other comprehensive income or loss. Credit loss is deemed to exist if the present value of expected future cash flows is less than the amortized cost basis of the debt security. For individual debt securities where the Company intends to sell the security or more-likely-than-not will be required to sell the security before recovery of its amortized cost, the other-than-temporary impairment is recognized in earnings equal to the entire difference between the security's cost basis and its fair value at the balance sheet date. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans and Allowance for Loan Losses

Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses and deferred loan fees and costs. Interest on loans is calculated by applying the simple interest method to daily balances of the principal amount outstanding.

The allowance for loan losses is established through a provision for loan losses charged to expense.

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The allowance for loan losses is reviewed periodically throughout the year to determine the appropriate level based on factors such as the methodology of allocating standard reserves to categories of loans, assigning specific reserves based on valuations of certain credits and a review of the appropriateness of the unallocated reserve.

There are several factors related to the allowance for loan losses that are individually reviewed to determine the level of specific reserves, such as the economic condition and outlook for certain industry or loan type concentrations, non-accrual loans, impaired loans, real estate under foreclosure, and classified loans. These reserves are assigned to meet the probable losses related to specific loans that have been identified as impaired.

The standard reserve is determined through an analysis of past performance including historical loan losses within groups of loans. Consideration is given to adjusting formulas based on an assessment of various qualitative factors related to the loan portfolio, including but not limited to performance of the portfolio, lender experience, new loan products or strategies, and economic factors. Management follows a similar process to estimate its liability for off-balance-sheet commitments to extend credit. The unallocated reserve position represents the margin of imprecision of the allowance after the standard and specific reserve allocations have been met.

Loans past due 30 days or more are considered delinquent. Loans are charged against the allowance for loan losses when management believes that the collection of the principal is unlikely. The allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the loans, the estimated value of underlying collateral, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions. The allowance is an amount that management believes is appropriate to absorb possible losses on existing loans.

Management considers loans to be impaired when it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or based on the fair value of the underlying collateral if the loan is collateral-dependent. Small balance homogenous loans are collectively evaluated for impairment.

The accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful. Interest income on nonaccrual loans is recognized only to the extent that interest payments are received. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loan origination fees and certain direct loan origination costs are deferred and amortized as an adjustment to income over the lives of the related loans.

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Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters-of-credit, and standby letters-of-credit. Such financial instruments are recorded when they are funded.

Other Real Estate and Property Owned (OREO)

Assets acquired through, or in lieu of, loan foreclosure or repossession are held for sale and are initially recorded at fair value at the date of foreclosure or repossession. Subsequent to foreclosure or repossession, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net expenses from other real estate and property owned.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation computed on the straight-line and declining balance methods over the estimated useful lives of the assets.

Goodwill

On January 1, 2002, the Company adopted Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC or Codification) Topic 350, *Intangibles - Goodwill and Other*. Prior to the adoption of ASC Topic 350, goodwill related to branch acquisitions was amortized using the straight-line method over ten years. Goodwill amortization has been discontinued. Goodwill related to branch acquisitions and MFG is reviewed for impairment annually, or more frequently upon the occurrence of certain events.

Income Taxes

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

ASC Topic 740, *Income Taxes*, defines the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. ASC Topic 740 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2013 through 2015.

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Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Employee Stock Ownership Plan

Shares of the Company's common stock purchased by the Katahdin Trust Company Employee Stock Ownership Plan (ESOP) are held in a suspense account until released for allocation to participants. Shares released are allocated to each eligible participant based on the ratio of each participant's compensation, as defined in the ESOP, to the total compensation of all eligible plan participants. As the unearned shares are released from suspense, the Company recognizes compensation expense equal to the fair value of the ESOP shares committed to be released during the period. To the extent that the fair value of the ESOP shares differs from the cost of such shares, the difference is charged or credited to equity as surplus. Allocated and committed-to-be-released ESOP shares are considered outstanding for earnings per share calculations based on debt service payments. Other ESOP shares are excluded from earnings per share. The cost of unearned shares to be allocated to ESOP participants for future services not yet performed is reflected as a reduction of stockholders' equity.

Earnings Per Share

Basic earnings per share data is computed based on the weighted average number of the Company's common shares outstanding during the year, which excludes the unallocated shares of the ESOP. Potential common stock related to unvested restricted stock awards are considered in the calculation of weighted average shares outstanding for diluted earnings per share.

Derivative Financial Instruments Designated as Hedges

The Company recognizes all derivatives in the consolidated balance sheet at fair value. On the date the Company enters into the derivative contract, the Company designates the derivative as a hedge of either a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge") or a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value hedge"). The Company formally documents relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The Company also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in cash flows or fair values of hedged items. Changes in fair value of a derivative that is effective and that qualifies as a cash flow hedge are recorded in other comprehensive income or loss and are reclassified into earnings when the forecasted transaction or related cash flows affect earnings. Changes in fair value of a derivative that qualifies as a fair value hedge and the change in fair value of the hedged item are both recorded in earnings and offset each other when the transaction is effective. The Company discontinues hedge accounting when it determines that the derivative is no longer

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effective in offsetting changes in the cash flows of the hedged item, that it is unlikely that the forecasted transaction will occur, or that the designation of the derivative as a hedging instrument is no longer appropriate.

Recently Issued Accounting Pronouncements

In January 2016, FASB issued Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. The ASU was issued to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This ASU changes how entities account for equity investments that do not result in consolidation and are not accounted for under the equity method of accounting. The ASU also changes certain disclosure requirements and other aspects of GAAP, including a requirement for public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The ASU will not have a material effect on the Company's consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, *Leases*. The ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The ASU is effective for fiscal years beginning after December 15, 2019. Management is reviewing the guidance in the ASU to determine whether it will have a material effect on the Company's consolidated financial statements.

In March 2016, FASB issued ASU No. 2016-09, *Improvements to Employee Share-Based Payment Accounting*. The ASU was issued to simplify several aspects of share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The amendments in this ASU are effective for fiscal years beginning after December 15, 2017. The ASU will not have a material effect on the Company's consolidated financial statements.

In June 2016, FASB issued ASU No. 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. Under the new guidance, which will replace the existing incurred loss model for recognizing credit losses, banks, and other lending institutions will be required to recognize the full amount of expected credit losses. The new guidance, which is referred to as the current expected credit loss model, requires that expected credit losses for financial assets held at the reporting date that are accounted for at amortized cost be measured and recognized based on historical experience and current and reasonably supportable forecasted conditions to reflect the full amount of expected credit losses. A modified version of these requirements also applies to debt securities classified as available-for-sale. The ASU is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Management is evaluating the potential impact of the ASU and anticipates that it may have a material impact on the Company's consolidated financial statements.

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2. Cash and Due from Banks

The Bank is required to maintain certain reserves of vault cash or deposits with the Federal Reserve Bank. The amount of this reserve requirement, included in cash and due from banks, was approximately \$211,000 and \$77,000 as of December 31, 2016 and 2015, respectively.

3. Securities

Securities have been classified in the consolidated balance sheets according to management's intent. The amortized cost and fair value of securities, with gross unrealized gains and losses, follow:

	2016			
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<u>Securities Available-for-Sale</u>				
U.S. Treasury securities	\$ 1,966,000	\$ 15,000	\$ -	\$ 1,981,000
State and municipal	9,593,000	46,000	(161,000)	9,478,000
Corporate bonds	1,000,000	-	(79,000)	921,000
Mortgage-backed and CMO's	<u>75,509,000</u>	<u>371,000</u>	<u>(1,438,000)</u>	<u>74,442,000</u>
Total debt securities	88,068,000	432,000	(1,678,000)	86,822,000
Marketable equity securities	<u>500,000</u>	<u>-</u>	<u>(51,000)</u>	<u>449,000</u>
Total securities available-for-sale	<u>\$ 88,568,000</u>	<u>\$ 432,000</u>	<u>\$ (1,729,000)</u>	<u>\$ 87,271,000</u>
<u>Securities Held-to-Maturity</u>				
Mortgage-backed and CMO's	<u>\$ 12,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 12,000</u>
Total securities held-to-maturity	<u>\$ 12,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 12,000</u>

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Notes to Consolidated Financial Statements

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	2015			
	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<u>Securities Available-for-Sale</u>				
U.S. Treasury securities	\$ 3,409,000	\$ 21,000	\$ -	\$ 3,430,000
State and municipal	5,311,000	100,000	-	5,411,000
Corporate bonds	1,000,000	-	(108,000)	892,000
Mortgage-backed and CMO's	<u>62,442,000</u>	<u>535,000</u>	<u>(639,000)</u>	<u>62,338,000</u>
Total debt securities	72,162,000	656,000	(747,000)	72,071,000
Money market mutual funds	4,000	-	-	4,000
Marketable equity securities	<u>500,000</u>	<u>-</u>	<u>(74,000)</u>	<u>426,000</u>
Total securities available-for-sale	<u>\$ 72,666,000</u>	<u>\$ 656,000</u>	<u>\$ (821,000)</u>	<u>\$ 72,501,000</u>
<u>Securities Held-to-Maturity</u>				
Mortgage-backed and CMO's	<u>\$ 16,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,000</u>
Total securities held-to-maturity	<u>\$ 16,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,000</u>

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous loss position at December 31, 2016:

	Less than 12 months		12 months or longer		Total	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
Corporate bonds	\$ -	\$ -	\$ 421,000	\$ (79,000)	\$ 421,000	\$ (79,000)
State and municipal	6,638,000	(161,000)	-	-	6,638,000	(161,000)
Mortgage-backed and CMO's	51,666,000	(1,103,000)	8,289,000	(335,000)	59,955,000	(1,438,000)
Marketable equity securities	<u>-</u>	<u>-</u>	<u>449,000</u>	<u>(51,000)</u>	<u>449,000</u>	<u>(51,000)</u>
Total temporarily impaired securities	<u>\$ 58,304,000</u>	<u>\$ (1,264,000)</u>	<u>\$ 9,159,000</u>	<u>\$ (465,000)</u>	<u>\$ 67,463,000</u>	<u>\$ (1,729,000)</u>

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

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At December 31, 2016, unrealized losses within the marketable equity securities category relate to one individual security which had a continuous loss for more than one year. Unrealized losses within the mortgage-backed and collateralized mortgage obligations (CMO's) category relate to fifty-seven individual securities of which eleven had continuous losses for more than one year. Unrealized losses within the state and municipal bonds category relate to fourteen individual securities of which none had continuous losses for more than one year. Unrealized losses within the corporate bond category relate to one bond which had a continuous loss position for more than one year. The primary cause for unrealized losses within the debt securities is the impact movements in interest rates have had in comparison to the underlying yields on these securities.

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous loss position at December 31, 2015:

	Less than 12 months		12 months or longer		Total	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
Corporate bonds	\$ -	\$ -	\$ 393,000	\$ (108,000)	\$ 393,000	\$ (108,000)
Mortgage-backed and CMO's	30,173,000	(204,000)	14,736,000	(435,000)	44,909,000	(639,000)
Marketable equity securities	-	-	426,000	(74,000)	426,000	(74,000)
Total temporarily impaired securities	<u>\$ 30,173,000</u>	<u>\$ (204,000)</u>	<u>\$15,555,000</u>	<u>\$ (617,000)</u>	<u>\$45,728,000</u>	<u>\$ (821,000)</u>

At December 31, 2015, unrealized losses within the marketable equity securities category relate to one individual security which had a continuous loss for more than one year. Unrealized losses within the mortgage-backed and CMO's category relate to forty-two individual securities of which sixteen had continuous losses for more than one year. Unrealized losses within the corporate bond category relate to one bond which had a continuous loss position for more than one year. The primary cause for unrealized losses within the debt securities is the impact movements in interest rates have had in comparison to the underlying yields on these securities.

Management evaluates investments for other-than-temporary impairment (OTTI) based on the type of investment and the period of time the investment has been in an unrealized loss position. At December 31, 2016 and 2015, management has determined that the current unrealized losses on these securities are consistent with changes in the overall bond and equity markets caused by an increase in market yields and spread levels and the securities are not other-than-temporarily impaired. The exception to this is a mortgage-backed security at Banc of America Funding Corporation (BAFC). Management performed an internal analysis on the market value of its investment at BAFC as of December 31, 2016 and 2015, and recognized OTTI write-downs of this security of \$4,000 and \$2,000 for the years ended December 31, 2016 and 2015, respectively.

KATAHDIN BANKSHARES CORP. AND SUBSIDIARY

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

At December 31, 2016 and 2015, securities with a fair value of \$28,604,000 and \$24,474,000, respectively, were pledged to secure certain borrowings and municipal deposits and repurchase agreements as required or permitted by law.

The amortized cost and fair value of debt securities by contractual maturity at December 31, 2016 follow:

	Available-for-Sale		Held-to-Maturity	
	Amortized <u>Cost</u>	Fair <u>Value</u>	Amortized <u>Cost</u>	Fair <u>Value</u>
Over 1 year through 5 years	\$ 17,476,000	\$ 17,446,000	\$ -	\$ -
Over 5 years through 10 years	24,110,000	23,857,000	12,000	12,000
Over 10 years	<u>46,482,000</u>	<u>45,519,000</u>	<u>-</u>	<u>-</u>
	<u>\$ 88,068,000</u>	<u>\$ 86,822,000</u>	<u>\$ 12,000</u>	<u>\$ 12,000</u>

Mortgage-backed securities and CMO's are allocated among the above maturity groupings based on their final maturity dates.

The Bank's investment in Federal Home Loan Bank (FHLB) stock was evaluated for impairment and the Bank did not identify any events or changes in circumstances that may have had a significant adverse effect on the carrying value of that investment.

4. Loans

A summary of the loan balances follows:

	<u>2016</u>	<u>2015</u>
Mortgage loans on real estate		
Residential 1-4 family	\$ 140,407,000	\$ 139,381,000
Commercial	<u>296,737,000</u>	<u>262,691,000</u>
	437,144,000	402,072,000
Commercial loans	161,017,000	156,429,000
Municipal loans	6,986,000	6,873,000
Consumer installment loans	17,146,000	19,899,000
Business credit cards	<u>310,000</u>	<u>340,000</u>
Subtotal	622,603,000	585,613,000
Less: Allowance for loan losses	6,032,000	5,330,000
Add: Net deferred loan costs	<u>676,000</u>	<u>625,000</u>
Loans, net	<u>\$ 617,247,000</u>	<u>\$ 580,908,000</u>

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The following tables present the allowance for loan losses and select loan information for the years ended December 31, 2016 and 2015:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>2016 Total</u>
Allowance for loan losses						
Beginning balance	\$ 1,924,000	\$ 2,737,000	\$ 278,000	\$ 62,000	\$ 329,000	\$ 5,330,000
Provision for (reduction of) loan losses	556,000	818,000	34,000	86,000	(178,000)	1,316,000
Loans charged off	(481,000)	(254,000)	(120,000)	(59,000)	-	(914,000)
Recoveries of loans previously charged off	65,000	210,000	19,000	6,000	-	300,000
Ending balance	<u>\$ 2,064,000</u>	<u>\$ 3,511,000</u>	<u>\$ 211,000</u>	<u>\$ 95,000</u>	<u>\$ 151,000</u>	<u>\$ 6,032,000</u>
Individually evaluated for impairment	<u>\$ 42,000</u>	<u>\$ 332,000</u>	<u>\$ 30,000</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 404,000</u>
Collectively evaluated for impairment	<u>\$ 2,022,000</u>	<u>\$ 3,179,000</u>	<u>\$ 181,000</u>	<u>\$ 95,000</u>	<u>\$ 151,000</u>	<u>\$ 5,628,000</u>
Loans						
Ending balance	<u>\$168,313,000</u>	<u>\$296,737,000</u>	<u>\$140,407,000</u>	<u>\$ 17,146,000</u>		<u>\$ 622,603,000</u>
Individually evaluated for impairment	<u>\$ 2,278,000</u>	<u>\$ 5,632,000</u>	<u>\$ 1,003,000</u>	<u>\$ 69,000</u>		<u>\$ 8,982,000</u>
Collectively evaluated for impairment	<u>\$166,035,000</u>	<u>\$291,105,000</u>	<u>\$139,404,000</u>	<u>\$ 17,077,000</u>		<u>\$ 613,621,000</u>
	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>2015 Total</u>
Allowance for loan losses						
Beginning balance	\$ 1,848,000	\$ 3,503,000	\$ 316,000	\$ 60,000	\$ 172,000	\$ 5,899,000
Provision for (reduction of) loan losses	138,000	(349,000)	77,000	27,000	157,000	50,000
Loans charged off	(197,000)	(490,000)	(119,000)	(29,000)	-	(835,000)
Recoveries of loans previously charged off	135,000	73,000	4,000	4,000	-	216,000
Ending balance	<u>\$ 1,924,000</u>	<u>\$ 2,737,000</u>	<u>\$ 278,000</u>	<u>\$ 62,000</u>	<u>\$ 329,000</u>	<u>\$ 5,330,000</u>
Individually evaluated for impairment	<u>\$ 45,000</u>	<u>\$ 147,000</u>	<u>\$ 44,000</u>	<u>\$ 10,000</u>	<u>\$ -</u>	<u>\$ 246,000</u>
Collectively evaluated for impairment	<u>\$ 1,879,000</u>	<u>\$ 2,590,000</u>	<u>\$ 234,000</u>	<u>\$ 52,000</u>	<u>\$ 329,000</u>	<u>\$ 5,084,000</u>
Loans						
Ending balance	<u>\$163,642,000</u>	<u>\$262,691,000</u>	<u>\$139,381,000</u>	<u>\$ 19,899,000</u>		<u>\$ 585,613,000</u>
Individually evaluated for impairment	<u>\$ 675,000</u>	<u>\$ 5,779,000</u>	<u>\$ 1,343,000</u>	<u>\$ 94,000</u>		<u>\$ 7,891,000</u>
Collectively evaluated for impairment	<u>\$162,967,000</u>	<u>\$256,912,000</u>	<u>\$138,038,000</u>	<u>\$ 19,805,000</u>		<u>\$ 577,722,000</u>

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Management's judgment of the likelihood of a loss is demonstrated by the internal risk rating assigned to each loan in both the Commercial and Consumer portfolios.

Commercial: Commercial and Commercial Real Estate

The commercial portfolio is closely monitored for quality and the likelihood of loss. Based on the current information surrounding the facts and circumstances of the loan, an internal credit rating is assigned. Credit ratings 1-5 are deemed to be a performing loan with no significant likelihood of loss. The ratings are further measured with a 6 – special mention, 7 – substandard, 8 – doubtful, and 9 – loss. Each of these ratings is supported by the facts and circumstances surrounding the loan that would cause a higher probability of some loss and thus as the rating progresses down the scale a higher reserve for loan loss is allocated to the particular group mentioned.

Loans rated 1: Loans in this category include municipalities or other government establishments primarily engaged in providing general support for government or administration of education programs.

Loans rated 2: Loans in this category include borrowers of unquestioned credit standing and a consistently strong financial condition as evidenced by earnings, liquidity, leverage, and cash flow. Additionally, loans secured by cash collateral or properly margined marketable securities are considered rated 2.

Loans rated 3: These loans include borrowers that have most of the characteristics of a loan rated 2, but either the financial condition, management, or industry is not quite as strong.

Loans rated 4: These loans include borrowers that have a reasonable financial condition. While loans in this category are definitely sound, they do carry a higher risk. The borrower is generally profitable with occasional moderate losses.

Loans rated 5: These loans are considered "watch list." These loans are those commercial loans that, while creditworthy, exhibit some characteristics which require special attention by the loan officer. This is the lowest permissible rating for a new loan. Loans rated 5 must be closely monitored as any deterioration may be cause for prompt re-rating to 6 or lower. Principal areas of concern may be management problems, industry stress, financial deterioration, operating losses, inadequate cash flow, highly cyclical industries, or any other area that would negatively affect the borrower's ability to repay the obligation in full on a timely basis.

Loans rated 6: Loans in this category are considered "special mention." These loans are considered protected but may have potential weaknesses, which may weaken the asset or inadequately protect the Bank's credit position at some future date.

Loans rated 7: Loans in this category are considered "substandard." These loans might be inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Assets so classified often have well-defined weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

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Loans rated 8: Loans in this category are considered “doubtful.” Loans classified as doubtful have all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses may make collection or liquidation in full highly questionable and improbable on the basis of currently existing facts, conditions, and values. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage of strengthening of the asset, its rating as 9 is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans.

Loans rated 9: Loans in this category are considered “loss” or uncollectible. For these loans it is not practical or desirable to defer writing off the basically worthless loan even though partial recovery may be effected in the future.

Consumer: Residential 1-4 Family, Consumer – Installment and Consumer – Indirect Installment

These loans are broken out as either a pass or substandard. A loan is typically marked as substandard when it becomes 90 days past due or under certain circumstances such as bankruptcy or excessive tax liens. Higher reserves are allocated to substandard consumer loans as there would be a higher probability of loss.

The following tables summarize credit risk indicators by portfolio as of December 31, 2016 and 2015:

Commercial Credit Risk Exposure Credit Risk Profile by Internally Assigned Grade

	<u>Commercial</u>	<u>Commercial Real Estate</u>
2016		
Pass	\$ 158,700,000	\$ 279,892,000
Special mention	4,808,000	7,491,000
Substandard	4,805,000	9,354,000
Doubtful	-	-
Loss	-	-
2016 Total	<u>\$ 168,313,000</u>	<u>\$ 296,737,000</u>
2015		
Pass	\$ 158,062,000	\$ 250,450,000
Special mention	3,872,000	6,001,000
Substandard	1,708,000	6,240,000
Doubtful	-	-
Loss	-	-
2015 Total	<u>\$ 163,642,000</u>	<u>\$ 262,691,000</u>

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Consumer Credit Exposure Credit Risk Profile by Internally Assigned Grade

	Residential Real Estate	Consumer - Installment	Consumer - Indirect Installment
2016			
Pass	\$ 139,121,000	\$ 4,179,000	\$ 12,932,000
Substandard	<u>1,286,000</u>	<u>35,000</u>	<u>-</u>
2016 Total	<u>\$ 140,407,000</u>	<u>\$ 4,214,000</u>	<u>\$ 12,932,000</u>
2015			
Pass	\$ 138,207,000	\$ 4,231,000	\$ 15,613,000
Substandard	<u>1,174,000</u>	<u>41,000</u>	<u>14,000</u>
2015 Total	<u>\$ 139,381,000</u>	<u>\$ 4,272,000</u>	<u>\$ 15,627,000</u>

The following presents an aging analysis of past due loans as of December 31, 2016 and 2015:

	30-59 Days Past Due	60-90 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Loans on Nonaccrual	Recorded Investment Loans > 90 Days and Accruing
2016								
Commercial	\$1,556,000	\$ 49,000	\$ 113,000	\$ 1,718,000	\$ 166,595,000	\$ 168,313,000	\$ 2,244,000	\$ -
Commercial real estate	943,000	6,716,000	-	7,659,000	289,078,000	296,737,000	7,609,000	-
Residential real estate	976,000	19,000	5,000	1,000,000	139,407,000	140,407,000	1,037,000	5,000
Consumer – installment	-	-	-	-	4,214,000	4,214,000	35,000	-
Consumer – indirect installment	<u>214,000</u>	<u>24,000</u>	<u>-</u>	<u>238,000</u>	<u>12,694,000</u>	<u>12,932,000</u>	<u>-</u>	<u>-</u>
2016 Total	<u>\$3,689,000</u>	<u>\$6,808,000</u>	<u>\$ 118,000</u>	<u>\$10,615,000</u>	<u>\$ 611,988,000</u>	<u>\$ 622,603,000</u>	<u>\$ 10,925,000</u>	<u>\$ 5,000</u>
2015								
Commercial	\$ 855,000	\$ 191,000	\$ 210,000	\$ 1,256,000	\$ 162,386,000	\$ 163,642,000	\$ 652,000	\$ 75,000
Commercial real estate	462,000	676,000	532,000	1,670,000	261,021,000	262,691,000	3,605,000	-
Residential real estate	901,000	101,000	71,000	1,073,000	138,308,000	139,381,000	1,081,000	14,000
Consumer – installment	7,000	1,000	-	8,000	4,264,000	4,272,000	81,000	-
Consumer – indirect installment	<u>273,000</u>	<u>32,000</u>	<u>4,000</u>	<u>309,000</u>	<u>15,318,000</u>	<u>15,627,000</u>	<u>14,000</u>	<u>-</u>
2015 Total	<u>\$2,498,000</u>	<u>\$1,001,000</u>	<u>\$ 817,000</u>	<u>\$ 4,316,000</u>	<u>\$ 581,297,000</u>	<u>\$ 585,613,000</u>	<u>\$ 5,433,000</u>	<u>\$ 89,000</u>

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The Bank takes a conservative approach in credit risk management and remains focused on community lending and reinvesting, working closely with borrowers experiencing credit problems to assist in loan repayment or term modifications. Troubled debt restructured loans (TDRs) consist of loans where the Bank, for economic or legal reasons related to the borrower's financial difficulties, granted a concession to the borrower that it would not otherwise consider. TDRs involve term modifications or a reduction of either interest or principal that the Bank would not normally make for other borrowers with similar risk characteristics. Once such an obligation has been restructured, it will continue to remain in restructured status until paid in full. Current balances of loan modifications qualifying as TDRs during the years ended December 31, 2016 and 2015 were \$2,868,000 and \$2,900,000, respectively. Loans restructured due to credit difficulties that are now performing were \$2,980,000 and \$5,418,000 at December 31, 2016 and 2015, respectively.

At December 31, 2016 and 2015, the allowance related to TDRs was \$364,000 and \$199,000, respectively. The specific reserve component was determined by using the fair value of the underlying collateral, which was obtained through independent appraisals and internal evaluations, or by discounting the total expected future cash flows from the borrower. There were no commitments to lend additional funds to borrowers with loans classified as TDRs at December 31, 2016 and 2015.

In 2016, four commercial loans and one residential real estate loan did not perform according to the TDR terms and were subsequently charged off or transferred to OREO in the combined amount of \$220,000. In 2015, one commercial, one residential real estate, and one consumer loan did not perform according to the TDR terms and were subsequently charged off or transferred to OREO in the combined amount of \$131,000.

The following is a summary of all TDRs (accruing and non-accruing) by portfolio segment as of December 31, 2016 and 2015:

	Number of <u>Contracts</u>	Pre-Modification Outstanding Recorded <u>Investment</u>	Post-Modification Outstanding Recorded <u>Investment</u>	Current <u>Balance</u>
2016				
Commercial	29	\$ 2,253,000	\$ 1,809,000	\$ 2,006,000
Commercial real estate	33	7,567,000	5,210,000	4,731,000
Residential real estate	5	911,000	910,000	694,000
Consumer	<u>1</u>	<u>40,000</u>	<u>40,000</u>	<u>35,000</u>
2016 Total	<u>68</u>	<u>\$10,771,000</u>	<u>\$ 7,969,000</u>	<u>\$ 7,466,000</u>
2015				
Commercial	23	\$ 465,000	\$ 524,000	\$ 392,000
Commercial real estate	37	7,879,000	5,662,000	4,861,000
Residential real estate	<u>6</u>	<u>1,093,000</u>	<u>1,093,000</u>	<u>989,000</u>
2015 Total	<u>66</u>	<u>\$ 9,437,000</u>	<u>\$ 7,279,000</u>	<u>\$ 6,242,000</u>

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Impaired loans consist of non-accrual loans and TDRs. All impaired loans are allocated a portion of the allowance to cover potential losses.

The following table presents a summary of information pertaining to impaired loans by loan category as of December 31, 2016 and 2015:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Interest Income Recognized</u>
2016				
With no related allowance recorded:				
Commercial	\$ 1,970,000	\$ 1,970,000	\$ -	\$ 35,000
Commercial real estate	2,243,000	2,243,000	-	34,000
Residential real estate	822,000	822,000	-	5,000
Consumer	69,000	69,000	-	3,000
With an allowance recorded:				
Commercial	\$ 308,000	\$ 308,000	\$ 42,000	\$ 19,000
Commercial real estate	3,389,000	3,389,000	332,000	170,000
Residential real estate	181,000	181,000	30,000	11,000
Consumer	-	-	-	-
2016 Total:				
Commercial	\$ 2,278,000	\$ 2,278,000	\$ 42,000	\$ 54,000
Commercial real estate	5,632,000	5,632,000	332,000	204,000
Residential real estate	1,003,000	1,003,000	30,000	16,000
Consumer	69,000	69,000	-	3,000
2015				
With no related allowance recorded:				
Commercial	\$ 549,000	\$ 549,000	\$ -	\$ 15,000
Commercial real estate	4,361,000	4,361,000	-	121,000
Residential real estate	883,000	883,000	-	10,000
Consumer	84,000	84,000	-	1,000
With an allowance recorded:				
Commercial	\$ 126,000	\$ 126,000	\$ 45,000	\$ 7,000
Commercial real estate	1,418,000	1,418,000	147,000	42,000
Residential real estate	460,000	460,000	44,000	24,000
Consumer	10,000	10,000	10,000	1,000
2015 Total:				
Commercial	\$ 675,000	\$ 675,000	\$ 45,000	\$ 22,000
Commercial real estate	5,779,000	5,779,000	147,000	163,000
Residential real estate	1,343,000	1,343,000	44,000	34,000
Consumer	94,000	94,000	10,000	2,000

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The following is a summary of information pertaining to impaired loans:

	<u>2016</u>	<u>2015</u>
Impaired loans without a valuation allowance	\$ 5,104,000	\$ 5,877,000
Impaired loans with a valuation allowance	<u>3,878,000</u>	<u>2,014,000</u>
Total impaired loans	<u>\$ 8,982,000</u>	<u>\$ 7,891,000</u>
Valuation allowance related to impaired loans	<u>\$ 404,000</u>	<u>\$ 246,000</u>
Average investment in impaired loans	<u>\$ 8,677,000</u>	<u>\$ 11,041,000</u>

As of December 31, 2016, and 2015, there were six and seven, respectively, mortgage loans collateralized by residential real estate in the process of foreclosure with a total balance of \$331,000 and \$281,000, respectively.

5. Bank Premises and Equipment

A summary of the cost and accumulated depreciation of bank premises and equipment follows:

	<u>2016</u>	<u>2015</u>
Land	\$ 2,755,000	\$ 2,755,000
Buildings	11,901,000	11,862,000
Equipment	12,477,000	12,343,000
Leasehold improvements	1,112,000	1,112,000
Construction in progress	<u>170,000</u>	<u>-</u>
	28,415,000	28,072,000
Accumulated depreciation	<u>(16,253,000)</u>	<u>(14,900,000)</u>
	<u>\$ 12,162,000</u>	<u>\$ 13,172,000</u>

6. Investments in Limited Partnerships

Through June 2016, the Company held investments in limited partnerships with related New Market Tax Credits (NMTC). These investments are carried at cost and amortized on the effective yield method. The tax credits from these investments at December 31, 2015 are \$285,000, and are recorded as a reduction of income tax expense. Amortization of the investments in the limited partnerships for the years ended December 31, 2016 and 2015 totaled \$69,000 and \$264,000, respectively, and is recognized as a component of income tax expense in the consolidated statements of income. The carrying value of these investments at December 31, 2015 amounted to \$69,000, which is recorded in other assets. The Company participates in loans to the limited partnerships. The Company's total exposure to these limited partnerships at December 31, 2015 was \$9,713,000, which is comprised of the Company's equity investment in the limited partnerships and the balance of the loans receivable.

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7. Deposits

At December 31, 2016, the scheduled maturities of time deposits are as follows:

2017	\$ 139,653,000
2018	42,821,000
2019	30,350,000
2020	6,315,000
2021 and thereafter	<u>4,778,000</u>
	<u>\$223,917,000</u>

8. Advances from Federal Home Loan Bank

Pursuant to collateral agreements with the FHLB, advances are collateralized by all stock in the FHLB, qualifying first mortgages and securities available-for-sale.

Fixed-rate advances of \$20,178,000 and \$20,188,000 at December 31, 2016 and 2015, respectively, mature through August 2023. At December 31, 2016 and 2015, the interest rates on fixed-rate advances ranged from 0.00 to 0.74 percent. At December 31, 2016 and 2015, the weighted-average interest rates on fixed-rate advances were 0.69 percent and 0.43 percent, respectively.

The floating rate advance of \$1,000,000 at December 31, 2016 matures in January 2017. At December 31, 2016, the interest rate on the floating rate advance was 0.80 percent. There were no floating rate advances at December 31, 2015.

At December 31, 2016 and 2015, the Company also had \$1,000,000 available under a long-term line of credit with the FHLB.

The contractual maturities of advances at December 31, 2016 are as follows:

2017	\$ 21,000,000
2023	178,000

9. Other Borrowed Funds

Other borrowed funds of \$889,000 and \$540,000 at December 31, 2016 and 2015, respectively, consist of securities sold under agreements to repurchase.

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date, except for the term repurchase agreements. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. At December 31, 2016 and 2015, securities with a fair value of \$889,000 and \$540,000, respectively, were pledged to secure other borrowed funds.

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Information concerning securities sold under agreements to repurchase for the years ended December 31, 2016 and 2015 is summarized as follows:

	<u>2016</u>	<u>2015</u>
Average balance during the year	\$ 647,000	\$ 660,000
Average interest rate during the year	0.10%	0.11%
Maximum month-end balance during the year	\$ 889,000	\$ 983,000

At December 31, 2016, the Company also had \$10,000,000 available under lines of credit with other banks which were in addition to the line of credit disclosed in Note 8. There were no advances outstanding at December 31, 2016.

10. Capital Trust Securities

On October 14, 2003, the Company sponsored the creation of Katahdin Capital Trust II (the "Trust II"), a statutory business trust created under the laws of Delaware. The Company is the owner of all of the common securities of the Trust II. On October 16, 2003, the Trust II issued \$3,000,000 of London Interbank Offered Rate (LIBOR) floating rate plus 3.05% margin Capital Securities (the "Capital Securities II," and with the common securities, the "Trust Securities II"), the proceeds from which were used by the Trust II, along with the Company's \$93,000 capital contribution for the Common Securities II, to acquire \$3,093,000 aggregate principal amount of the Company's LIBOR floating rate plus 3.05% Junior Subordinated Deferrable Interest Debentures due October 16, 2033 (the "Debentures"), which constitute the sole assets of the Trust II. The Company has, through the Declaration of Trust which established the Trust II, the Common Securities II and Capital Securities II Guarantee Agreements, the Debentures and a related Indenture, taken together, fully, irrevocably and unconditionally guaranteed all of the Trust II's obligations under the Trust Securities II.

On December 20, 2005, the Company sponsored the creation of Katahdin Capital Trust III (the "Trust III"), a statutory business trust created under the laws of Delaware. The Company is the owner of all of the common securities of the Trust III. On December 22, 2005, the Trust III issued \$4,000,000 of LIBOR floating rate plus 1.50% margin Capital Securities (the "Capital Securities III," and with the common securities, the "Trust Securities III"), the proceeds from which were used by the Trust III, along with the Company's \$124,000 capital contribution for the Common Securities III, to acquire \$4,124,000 aggregate principal amount of the Company's LIBOR floating rate plus 1.50% Junior Subordinated Deferrable Interest Debentures due January 7, 2036 (the "Debentures"), which constitute the sole assets of the Trust III. The Company has, through the Declaration of Trust which established the Trust III, the Common Securities III and Capital Securities III Guarantee Agreements, the Debentures and a related Indenture, taken together, fully, irrevocably and unconditionally guaranteed all of the Trust III's obligations under the Trust Securities III.

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11. Income Taxes

Allocation of federal and state income taxes between current and deferred portions is as follows:

	<u>2016</u>	<u>2015</u>
Current tax provision		
Federal	\$ 1,230,000	\$ 2,880,000
State	<u>120,000</u>	<u>102,000</u>
	1,350,000	2,982,000
Deferred federal tax liability (benefit)	<u>514,000</u>	<u>(681,000)</u>
	<u>\$ 1,864,000</u>	<u>\$ 2,301,000</u>

The income tax provision differs from the expense that would result from applying federal statutory rates to income before income taxes, as follows:

	<u>2016</u>	<u>2015</u>
Computed tax expense	\$ 2,230,000	\$ 2,383,000
Increase (reduction) in income taxes resulting from:		
Tax exempt interest	(121,000)	(84,000)
State taxes, net of federal benefit	79,000	67,000
Income from life insurance	(105,000)	(92,000)
Preferred stock dividends	(5,000)	(5,000)
Tax credits, net of investment amortization	(66,000)	(14,000)
Other	<u>(148,000)</u>	<u>46,000</u>
	<u>\$ 1,864,000</u>	<u>\$ 2,301,000</u>

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Items which give rise to deferred income tax assets and liabilities are as follows:

	<u>2016</u>	<u>2015</u>
Deferred tax assets		
Other-than-temporary impairment of investment securities	\$ 73,000	\$ 72,000
Allowance for loan losses	2,051,000	1,812,000
Employee benefit plans	799,000	861,000
Net unrealized loss on derivative instruments	164,000	379,000
Net unrealized loss on securities available-for-sale	441,000	56,000
Other	<u>96,000</u>	<u>125,000</u>
	<u>3,624,000</u>	<u>3,305,000</u>
Deferred tax liabilities		
Depreciation	808,000	1,015,000
Amortization of goodwill	1,629,000	1,578,000
Amortization of interest rate cap premium	192,000	196,000
Prepaid expenses	124,000	154,000
Investment in NMTC	-	177,000
Other	<u>1,000</u>	<u>-</u>
	<u>2,754,000</u>	<u>3,120,000</u>
Net deferred tax asset	<u>\$ 870,000</u>	<u>\$ 185,000</u>

No valuation allowance is deemed necessary for the deferred income tax asset. The net deferred income tax asset is included in other assets in the consolidated balance sheets.

12. Earnings Per Share

The following sets forth the computation of basic and diluted earnings per common share for 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Net income available to common shareholders, as reported	\$ <u>3,939,000</u>	\$ <u>3,900,000</u>
Weighted-average common shares outstanding	3,399,826	3,404,367
Effect of unvested restricted stock grants	<u>-</u>	<u>-</u>
Diluted weighted-average common shares	<u>3,399,826</u>	<u>3,404,367</u>
Basic earnings per common share	\$ 1.16	\$ 1.15
Diluted earnings per common share	\$ 1.16	\$ 1.15

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13. Financial Instruments with Off-Balance-Sheet Risk

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

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

At December 31, 2016 and 2015, the contractual amounts of the Company's financial instruments were as follows:

	Contract Amount	
	<u>2016</u>	<u>2015</u>
Lending-related instruments:		
Home equity lines-of-credit	\$ 19,580,000	\$ 19,579,000
Other lines-of-credit	57,484,000	48,836,000
Credit card arrangements	2,265,000	2,062,000
Letters-of-credit	2,505,000	2,723,000
Derivative financial instruments:		
Notional amounts of interest rate swaps	96,240,000	4,000,000
Notional amounts of interest rate caps	28,000,000	28,000,000

Commitments to extend credit are agreements to lend to a customer as long as 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. The commitments for lines-of-credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements.

Unfunded commitments under commercial lines-of-credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines-of-credit are uncollateralized, usually do not contain a specified maturity date, and may not be drawn upon to the total extent to which the Company is committed.

Commercial letters-of-credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters-of-credit are primarily issued to support public and private borrowing arrangements. Substantially all letters-of-credit issued have expiration dates within one year. The credit risk involved in issuing letters-of-credit is essentially the same as that involved in extending loan facilities to customers. The Company generally holds collateral supporting those commitments if deemed necessary.

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To reduce credit risk related to the use of 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.

14. Significant Group Concentrations of Credit Risk

A large portion of the Company's loan portfolio consists of single family residential loans and commercial real estate loans in Maine. The local economy depends heavily on Maine industries including the agricultural and forest industries, which are subject to annual variations. Accordingly, the collectibility of a substantial portion of the Company's loan portfolio is dependent on the health of Maine's economy.

The Company's policy for requiring collateral is to obtain security in excess of the amount borrowed. The amount of collateral obtained is based on management's credit evaluation of the borrower. The Company requires appraisals of real property held as collateral. For consumer loans, the Company will accept security which has a title certificate. Collateral held for commercial loans may include accounts receivable, inventory, property and equipment, and income-producing properties. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

The contractual amount of credit-related financial instruments such as commitments to extend credit and letters-of-credit represents the amount of potential accounting loss should the contract be fully drawn upon, the customer default, and the value of any existing collateral become worthless.

15. Legal Contingencies

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

16. Minimum Regulatory Capital Requirements

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

Effective January 1, 2015, the Bank implemented the Basel III regulatory framework. These new rules and framework revised minimum capital requirements and adjusted prompt corrective action thresholds. Under the Basel III regulatory framework, the quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital and common equity Tier 1 (as defined in

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the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Effective in 2015, the Company is considered a Small Bank Holding Company and therefore not subject to the Basel III capital rules. Regulatory capital requirements limit a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% above its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in from January 1, 2016 through January 1, 2019, when the full capital conservation buffer requirement will be effective. As of December 31, 2016, the Bank had a capital conservation buffer of 5.02% of risk-weighted assets, which was in excess of the phased-in regulatory requirement of 0.625%. Management believes, as of December 31, 2016 and 2015, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2016, 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, an institution must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31, 2016 and 2015 are also presented in the table.

	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2016</u>						
Total Capital to Risk-Weighted Assets						
Bank	\$ 74,235,000	13.0%	\$ 45,627,000	8.0%	\$ 57,033,000	10.0%
Tier 1 Capital to Risk-Weighted Assets						
Bank	68,169,000	12.0	34,220,000	6.0	45,627,000	8.0
Common Equity Tier 1 Capital to Risk-Weighted Assets						
Bank	68,169,000	12.0	25,665,000	4.5	37,072,000	6.5
Tier 1 Capital to Average Assets						
Bank	68,169,000	9.2	29,791,000	4.0	37,239,000	5.0

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	Actual		Minimum Capital Requirement		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2015</u>						
Total Capital to Risk-Weighted Assets						
Bank	\$ 70,921,000	13.3%	\$ 42,540,000	8.0%	\$ 53,175,000	10.0%
Tier 1 Capital to Risk-Weighted Assets						
Bank	65,558,000	12.3	31,905,000	6.0	42,540,000	8.0
Common Equity Tier 1 Capital to Risk-Weighted Assets						
Bank	65,558,000	12.3	23,929,000	4.5	34,564,000	6.5
Tier 1 Capital to Average Assets						
Bank	65,558,000	9.4	27,657,000	4.0	34,571,000	5.0

17. Employee Benefit Plans

The Company has a safe harbor 401(k) plan whereby substantially all employees participate in the plan. Employees may contribute a portion of their compensation subject to certain limits based on federal tax laws. The Company makes safe harbor matching contributions equal to 100% of the first 3% of an employee's compensation plus 50% of the next 2% of an employee's compensation in addition to a discretionary contribution. For the years ended December 31, 2016 and 2015, expense attributable to the plan amounted to \$348,000 and \$313,000, respectively.

The Company has established a nonqualified supplemental executive retirement plan for the benefit of key employees. The amount of each benefit is guaranteed contingent upon employee vesting schedules. The present value of these benefits, being expensed over the employment service period, amounted to \$281,000 and \$186,000 for 2016 and 2015, respectively. Life insurance policies were acquired for the purpose of serving as the primary funding source. The cash value of these policies was \$11,421,000 and \$9,612,000 at December 31, 2016 and 2015, respectively, and is included in other assets.

For 2016 and 2015, in addition to a retainer fee of \$13,000 and \$12,000, respectively, for regular directors, \$15,000 and \$14,000, respectively, for the vice-chairman, \$16,000 and \$15,000, respectively, for the chairman, outside directors of the Bank received \$675 and \$600, respectively, for each Board meeting attended, and \$675 and \$600, respectively, for each Board subcommittee meeting attended.

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Certain directors are eligible to participate in the Bank's health insurance plan. Directors are reimbursed for mileage expense or other similar expenses.

18. Restricted Stock Plan

The Company established a restricted stock plan during 2010 with 100,000 shares currently authorized by the Board of Directors for the compensation committee of the Board to administer. The compensation committee did not grant restricted stock during 2016 or 2015. A total of 11,897 shares have been issued under the restricted stock plan since inception, all of which are vested.

19. Other Noninterest Expenses

The components of other noninterest expenses which are in excess of 1% of total revenues (total interest and dividend income and noninterest income) and not shown separately in the consolidated statements of income are as follows for the years ended December 31:

	<u>2016</u>	<u>2015</u>
Printing, postage and supplies	\$ 506,000	\$ 564,000
Professional fees	383,000	369,000

20. Related Party Transactions

In the ordinary course of business, the Company has granted loans to principal officers and directors and their affiliates amounting to \$14,568,000 and \$11,128,000 at December 31, 2016 and 2015, respectively. Deposits from related parties held by the Company at December 31, 2016 and 2015 amounted to \$6,138,000 and \$5,240,000, respectively.

21. Employee Stock Ownership Plan

All Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. In October 2016, the Bank's ESOP purchased 25,500 shares of the Katahdin Bankshares Corp. common stock for \$287,000. The ESOP borrowed the loan amount of \$287,000 from Katahdin Bankshares Corp., and the loan is repayable annually with an interest rate of 2.55% for the term of 4 years. The loan is secured by the shares purchased by the ESOP. Participants' benefits become fully vested after five years of service. The Bank's contributions are the primary source of funds for the ESOP's repayment of the loan. Principal and interest payments for the year ended December 31, 2016 totaled \$15,000.

As of December 31, 2016, the remaining principal balance is payable as follows:

2018	\$ 93,000
2019	97,000
2020	<u>83,000</u>
	<u>\$ 273,000</u>

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Shares held by the ESOP include the following at December 31, 2016:

Allocated	1,306
Unallocated	<u>24,194</u>
	<u>25,500</u>

The fair value of the unallocated shares as of December 31, 2016 was approximately \$314,000.

22. Fair Value

GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon model-based techniques incorporating various assumptions including interest rates, prepayment speeds, and credit losses. Assets and liabilities valued using model-based techniques are classified as either Level 2 or Level 3, depending on the lowest level classification of an input that is considered significant to the overall valuation. 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.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

Securities available-for-sale: Fair values for securities available-for-sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The fair values of securities available-for-sale are classified as Level 2.

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Derivatives: Derivatives are reported at fair value utilizing Level 2 inputs obtained from third parties to value interest rate caps and swaps.

Assets and liabilities measured at fair value on a recurring basis are summarized below:

Fair Value Measurements at December 31, 2016 and 2015, Using

	<u>Total</u>	<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
<u>December 31, 2016</u>				
Assets				
Securities available-for-sale				
U.S. Treasury securities	\$ 1,981,000	\$ -	\$ 1,981,000	\$ -
State and municipal	9,478,000	-	9,478,000	-
Corporate bonds	921,000	-	921,000	-
Mortgage-backed and CMO's	<u>74,442,000</u>	<u>-</u>	<u>74,442,000</u>	<u>-</u>
Total debt securities	86,822,000	-	86,822,000	-
Marketable equity securities	<u>449,000</u>	<u>449,000</u>	<u>-</u>	<u>-</u>
Total securities available-for-sale	87,271,000	449,000	86,822,000	-
Derivative instruments	<u>2,533,000</u>	<u>-</u>	<u>2,533,000</u>	<u>-</u>
Total assets	<u>\$ 89,804,000</u>	<u>\$ 449,000</u>	<u>\$ 89,355,000</u>	<u>\$ -</u>
Liabilities				
Derivative instruments	<u>\$ 1,464,000</u>	<u>\$ -</u>	<u>\$ 1,464,000</u>	<u>\$ -</u>

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	<u>Total</u>	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2015</u>				
Assets				
Securities available-for-sale				
U.S. Treasury securities	\$ 3,430,000	\$ -	\$ 3,430,000	\$ -
State and municipal	5,411,000	-	5,411,000	-
Corporate bonds	892,000	-	892,000	-
Mortgage-backed and CMO's	<u>62,338,000</u>	<u>-</u>	<u>62,338,000</u>	<u>-</u>
Total debt securities	72,071,000	-	72,071,000	-
Money market mutual funds	4,000	4,000	-	-
Marketable equity securities	<u>426,000</u>	<u>426,000</u>	<u>-</u>	<u>-</u>
Total securities available-for-sale	72,501,000	430,000	72,071,000	-
Derivative instruments	<u>956,000</u>	<u>-</u>	<u>956,000</u>	<u>-</u>
Total assets	<u>\$ 73,457,000</u>	<u>\$ 430,000</u>	<u>\$ 73,027,000</u>	<u>\$ -</u>
Liabilities				
Derivative instruments	<u>\$ 130,000</u>	<u>\$ -</u>	<u>\$ 130,000</u>	<u>\$ -</u>

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

Impaired loans: A loan is considered to be impaired when it is probable that all of the principal and interest due under the original underwriting terms of the loan may not be collected. Impairment is measured based on the fair value of the underlying collateral or the present value of future cash flows. The Company measures impairment on all nonaccrual loans for which it has established specific reserves as part of the specific allocated allowance component of the allowance for loan losses. The fair values of impaired loans are classified as Level 2.

Other real estate and property owned: Real estate acquired through foreclosure is recorded at fair value. The fair value of other real estate and property owned is based on property appraisals and an analysis of similar properties currently available. The fair values of other real estate and property owned are classified as Level 2.

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Assets and liabilities measured at fair value on a nonrecurring basis are summarized below:

Fair Value Measurements at December 31, 2016 and 2015, Using

	<u>Total</u>	<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
<u>December 31, 2016</u>				
Assets				
Impaired loans (market approach)	\$ 3,474,000	\$ -	\$ 3,474,000	\$ -
Other real estate and property owned (market approach)	454,000	-	454,000	-
<u>December 31, 2015</u>				
Assets				
Impaired loans (market approach)	\$ 1,768,000	\$ -	\$ 1,768,000	\$ -
Other real estate and property owned (market approach)	399,000	-	399,000	-

Certain impaired loans were written down to their value of \$3,474,000 and \$1,768,000 at December 31, 2016 and 2015, respectively, resulting in an impairment charge through the allowance for loan losses.

GAAP requires disclosures of fair value information about financial instruments, whether or not recognized in the balance sheet, if the fair values can be reasonably determined. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques using observable inputs when available. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

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

Cash and due from banks and interest bearing deposits in banks: The carrying amount reported in the balance sheet for cash and cash equivalents approximates fair value.

Securities: Fair values for securities, excluding FHLB stock, are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical

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technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The carrying value of FHLB stock approximates fair value based on the redemption provisions of the FHLB.

Loans receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. 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 value of impaired loans is primarily based upon appraisals of the collateral by third-party appraisers and brokers' opinions by third-party brokers. The appraisals and opinions are based upon comparable prices for similar assets in active markets for residential real estate loans, and less active markets for commercial loans.

Deposit liabilities: The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregate expected monthly maturities on time deposits.

Advances from Federal Home Loan Bank: The fair values of these borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Other borrowed funds: The fair values of these borrowed funds are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

Junior subordinated debentures: The carrying values of these instruments approximate fair value.

Accrued interest: The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet instruments: The Company's off-balance-sheet instruments consist of loan commitments. Fair values for loan commitments have not been presented as the future revenue derived from such financial instruments is not significant.

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The estimated fair values, and related carrying amounts, of the Company's financial instruments are as follows:

	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Fair Value Measurement at December 31, 2016</u>		
			<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Financial assets					
Cash and due from banks	\$ 6,450,000	\$ 6,450,000	\$ 6,450,000	\$ -	\$ -
Interest bearing deposits in banks	4,873,000	4,873,000	4,873,000	-	-
Securities available-for-sale	87,271,000	87,271,000	449,000	86,822,000	-
Securities held-to-maturity	12,000	12,000	-	12,000	-
FHLB stock	1,682,000	1,682,000	-	1,682,000	-
Loans receivable, net:					
Commercial	166,391,000	166,999,000	-	266,000	166,733,000
Commercial real estate	293,476,000	288,426,000	-	3,057,000	285,369,000
Residential real estate	140,314,000	139,340,000	-	151,000	139,189,000
Consumer	<u>17,066,000</u>	<u>17,262,000</u>	<u>-</u>	<u>-</u>	<u>17,262,000</u>
Loan receivable, net	617,247,000	612,027,000	-	3,474,000	608,553,000
Accrued interest receivable	1,618,000	1,618,000	-	1,618,000	-
Derivative instruments	2,533,000	2,533,000	-	2,533,000	-
Financial liabilities					
Deposits	652,969,000	638,800,000	-	638,800,000	-
Advances from FHLB	21,178,000	21,182,000	-	21,182,000	-
Other borrowed funds	889,000	889,000	-	889,000	-
Accrued interest payable	183,000	183,000	-	183,000	-
Junior subordinated debentures	7,217,000	7,217,000	-	7,217,000	-
Derivative instruments	1,464,000	1,464,000	-	1,464,000	-

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			Fair Value Measurement at December 31, 2015		
	Carrying Amount	Fair Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial assets					
Cash and due from banks	\$ 6,388,000	\$ 6,388,000	\$ 6,388,000	\$ -	\$ -
Interest bearing deposits in banks	5,157,000	5,157,000	5,157,000	-	-
Securities available-for-sale	72,501,000	72,501,000	430,000	72,071,000	-
Securities held-to-maturity	16,000	16,000	-	16,000	-
FHLB stock	2,319,000	2,319,000	-	2,319,000	-
Loans receivable, net:					
Commercial	161,801,000	163,392,000	-	81,000	163,311,000
Commercial real estate	260,087,000	259,285,000	-	1,271,000	258,014,000
Residential real estate	139,173,000	139,306,000	-	416,000	138,890,000
Consumer	19,847,000	20,216,000	-	-	20,216,000
Loan receivable, net	580,908,000	582,199,000	-	1,768,000	580,431,000
Accrued interest receivable	1,713,000	1,713,000	-	1,713,000	-
Derivative instruments	956,000	956,000	-	956,000	-
Financial liabilities					
Deposits	606,205,000	597,112,000	-	597,112,000	-
Advances from FHLB	20,188,000	20,204,000	-	20,204,000	-
Other borrowed funds	540,000	540,000	-	540,000	-
Accrued interest payable	156,000	156,000	-	156,000	-
Junior subordinated debentures	7,217,000	7,217,000	-	7,217,000	-
Derivative instruments	130,000	130,000	-	130,000	-

23. Preferred Stock

The Company has authorized the issuance of up to 20,000 shares of preferred stock at any one time.

Preferred Series C consisting of 11,000 shares with a purchase price of \$1,000 per share was outstanding in 2015 until April 27, 2015. The Preferred Series C shares called for varying rates of non-cumulative dividends. The applicable rate on the Preferred Series C shares ranged from 1% to 5% per year for the first nine quarters following the investment. The Company maintained small business lending levels in order to meet the 1% dividend rate on Preferred Series C shares for eight out of the nine completed quarters, the Bank met the requirements for a 2% dividend for one quarter. From the 10th quarter through 4.5 years following the investment, the dividend rate remained fixed at a rate of 1%. After the end of the 4.5 year period following the investment, the applicable dividend rate would have been fixed at 9%. However, approximately one year prior to the dividend increase, the Preferred Series C 11,000 shares were redeemed by the Company on April 27, 2015.

On June 27, 2014, the Company issued 4,000 shares of Preferred Series D floating rate non-cumulative perpetual preferred stock at an issuance price of \$2,500 per share. The net proceeds from the issuance totaled \$9,603,000. The dividend will be set quarterly at a floating rate of 3

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month LIBOR plus 4.25%, with a floor of 8.75%. Dividends on Preferred Series D are payable quarterly in arrears on January 15, April 15, July 15, and October 15 of each year.

Preferred Series D qualifies as Tier 1 capital on the Company's books for regulatory purposes and rank senior to the Company's common stock and senior or at an equal level in the Company's capital structure to any other shares of preferred stock the Company may issue in the future. The dividend rights have priority over all common stock dividends, and thus the dividends on the preferred stock need to be paid before the Company can pay dividends on the common stock.

The Company has the option to redeem the Preferred Series D shares, in whole or in part, from time to time, on or after the five year anniversary of the issuance, at a redemption price of \$2,500 per share.

24. Interest Rate Swaps and Caps

The Company uses derivative instruments as partial hedges against large fluctuations in interest rates. At least quarterly, all financial instruments are reviewed as part of the asset/liability management process. The financial instruments are factored into the Company's overall interest rate risk position. The Company regularly reviews the credit quality of the counterparty from which the instruments have been purchased. The Company uses derivative financial instruments for risk management purposes and not for trading or speculative purposes. The Company controls the credit risk of these instruments through collateral, credit approvals, and monitoring procedures. The derivative instruments contain provisions that require the Company to post collateral with the counterparty for its contracts that are in a net loss position based on their fair value and the Company's credit rating. At December 31, 2016 and 2015, the Company had posted \$100,000 and \$300,000, respectively, of cash as collateral.

The Company has a notional amount of \$4,000,000 in an interest rate swap agreement on its junior subordinated debentures. As the interest on these debentures is a variable rate, the Company swapped the variable cost for a fixed cost. On March 30, 2010, the Company purchased a 7-year interest rate swap with an effective date of April 7, 2010 and a notional amount of \$4,000,000 with a fixed cost of 3.48% based on 3 month LIBOR and a maturity date of April 7, 2017. The fair value of the swap agreement was a liability at December 31, 2016 and 2015 of \$27,000 and \$130,000, respectively. As this instrument qualifies as a highly effective cash flow hedge, the change in fair value was recorded in other comprehensive income (loss), net of tax.

On March 30, 2010, the Company purchased an interest rate protection agreement (cap) with a notional amount of \$3,000,000, a strike rate of 3.0% based on 3 month LIBOR and a termination date of April 7, 2017. The cap was acquired to limit the Company's exposure to interest rates on its junior subordinated debentures. Under the agreement, the Company paid up front premiums of \$270,000, which the Company is amortizing based on the expense amortization schedule established at the inception of the hedge, with the corresponding adjustment to the income statement. At inception, the hedging relationship was expected to be 100% effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. The cap had no fair value at December 31, 2016 and 2015. As this instrument qualifies as a highly effective cash flow hedge, the change in fair value was recorded in other comprehensive income (loss), net of tax.

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On April 9, 2014, the Bank purchased an interest rate protection agreement (cap) with a notional amount of \$25,000,000, a cap strike rate of 0.23% based on 3 month LIBOR and a termination date of April 4, 2019. The cap was acquired to limit the Bank's exposure to rising interest rates of the LIBOR component of wholesale funding. Under the agreement, the Bank paid up front premiums of \$1,998,000, which the Bank is amortizing based on the expense amortization schedule established at the inception of the hedge, with the corresponding adjustment to the income statement. At inception, the hedging relationship was expected to be 100% effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. The fair value of the cap at December 31, 2016 and 2015 was \$716,000 and \$956,000, respectively. As this instrument qualifies as a highly effective cash flow hedge, the change in fair value was recorded in other comprehensive income (loss), net of tax.

Effective July 1, 2016, the Bank entered an interest rate swap agreement with a notional amount of \$15,000,000 and a termination date of June 30, 2020. The swap was entered into to limit the Bank's exposure to rising interest rates of the LIBOR component of wholesale funding. Under the agreement, the Bank agreed to pay a fixed interest rate of 0.855% for the term of the swap agreement and shall receive a variable rate of 1 month LIBOR over the same period. At inception, the hedging relationship was expected to be 100% effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. The fair value of the swap at December 31, 2016 was \$381,000. As this instrument qualifies as a highly effective cash flow hedge, the change in fair value was recorded in other comprehensive income (loss), net of tax.

Beginning in 2016, the Bank began entering into interest rate swap agreements executed with commercial banking customers to facilitate customers' risk management strategies. In addition to the swap agreement with the borrower, the Bank enters into a second "back-to-back" swap agreement with a third party; the general terms of the swap mirror those of the first swap agreement. In entering into this transaction, the Bank has offset its interest rate risk exposure to the swap agreement with the borrower. All interest rate swaps are valued at observable market prices for similar instruments or valued using observable market interest rates.

The fair value of customer related interest rate swaps, which are included in other assets (accrued expenses and other liabilities) as of December 31, 2016 were \$1,436,000 and \$(1,436,000), respectively, resulting in \$0 net customer related swap.

The outstanding notional amounts of interest rate swaps entered into on behalf of customers at December 31, 2016 was \$38,620,000 of swaps receive fixed rate of interest and \$38,620,000 of swaps pay fixed rate of interest.

25. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about the conditions that existed at the balance sheet date, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the balance sheet date, but arose after that date. Management has evaluated subsequent events occurring through February 2, 2017, the date the financial statements were available to be issued.