



2016 Annual Report to Shareholders

NORTHWAY FINANCIAL, INC.
2016 ANNUAL REPORT

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SELECTED FINANCIAL HIGHLIGHTS

At or for the years ended December 31, (\$000 Omitted, except per share data)	2016	2015	2014	2013	2012
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Balance Sheet Data:

Total assets	\$ 889,598	\$ 933,604	\$ 925,713	\$ 898,329	\$ 873,629
Securities available-for-sale, at fair value	261,008	254,476	221,647	184,527	206,703
Loans, net of unearned income	553,472	555,922	603,593	642,259	573,577
Allowance for loan losses	7,878	8,623	8,806	11,190	10,012
Other real estate owned	118	463	1,138	1,581	1,126
Goodwill	9,934	9,934	9,934	9,934	9,934
Core deposit intangibles, net	82	132	194	267	352
Deposits	737,732	757,922	726,630	694,359	668,464
Short-term borrowings	50,528	44,042	34,850	35,465	30,270
Long-term debt	20,620	55,527	65,434	80,796	87,656
Shareholders' equity	74,403	70,307	90,918	82,188	80,878

Income Statement Data:

Net interest and dividend income	25,911	\$ 27,080	\$ 28,360	\$ 28,049	\$ 25,779
Provision for loan losses	-	-	1,503	2,820	2,112
Noninterest income	8,352	7,903	10,955	11,862	11,463
Noninterest expense	29,302	26,018	27,535	27,377	26,891
Net income	4,015	6,485	7,853	7,206	6,494
Net income applicable to common stock	4,015	6,212	7,585	6,925	5,854

Per Common Share Data: (1)(2)

Net income – basic	\$ 1.46	\$ 2.26	\$ 2.76	\$ 2.57	\$ 2.23
Net income – assuming dilution	1.46	2.26	2.76	2.57	2.23
Cash dividends declared and paid, common stock	0.64	0.64	0.64	0.64	0.33
Book value	27.04	25.55	24.48	21.32	21.90
Tangible book value	23.40	21.89	20.80	17.05	17.52

Selected Ratios:

Return on average assets	0.44 %	0.69 %	0.84 %	0.82 %	0.77 %
Return on average shareholders' equity	5.38	7.01	8.96	8.89	8.25
Common stock dividend payout	43.86	28.33	23.22	24.82	14.77
Average shareholders' equity to average assets	8.23	9.86	9.40	9.20	9.31

(1) In 2013, the Company paid a stock dividend of 5%.

(2) Earnings per share and dividends declared per share for 2013 & 2012 have been adjusted to reflect the impact of the stock dividends paid.

NATURE OF OPERATIONS

Northway Financial, Inc. (“Northway” or the “Company”), headquartered in North Conway, New Hampshire, is a bank holding company formed in 1997 under the laws of New Hampshire and is registered under the Bank Holding Company Act of 1956, as amended. Northway’s only business activity is to own all of the shares of, and provide management, capital and operational support to Northway Bank (“Bank”), its subsidiary headquartered in Berlin, New Hampshire, and its Delaware statutory business trusts, Northway Capital Trust III and Northway Capital Trust IV. Unless the context otherwise requires, references herein to the “Company” include Northway and its subsidiary, the Bank. The Bank is engaged principally in the business of attracting deposits from the general public and investing those deposits in securities, commercial loans, real estate loans and consumer loans. The Bank does not engage in any specialized finance or capital markets activities.

FORWARD-LOOKING STATEMENTS

Certain statements in this report are “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include, but are not limited to, projections of revenue, income or loss, plans for future operations and acquisitions, projections based on assumptions regarding market and liquidity risk, and plans related to products or services of the Company. Forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. To the extent any such risks, uncertainties and contingencies are realized, the Company’s actual results, performance or achievements could differ materially from anticipated results, performance or achievements. Factors that might affect such forward-looking statements include, among other factors, changes in general economic and business conditions or the economy and business conditions of the Bank’s primary market area, interest rate fluctuations, a prolonged continuation of the current interest rate environment, the demand for the Company’s products and services, competitive factors in the industries in which the Company competes, changes in government regulation, significant changes in loan losses which may affect the Company’s allowance for loan losses and the related provision for loan losses, and changes in the securities market that would affect the performance of the Company’s investment portfolio.

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

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

2016 OVERVIEW

The Company reported net income of \$4,015 in 2016 compared to net income of \$6,485 in 2015. In 2016, \$4,015, or \$1.46 per common share, was available to common shareholders compared to \$6,212, or \$2.26 per common share, in 2015. Return on average shareholders’ equity was 5.38% in 2016 compared to 7.01% in 2015. Return on average assets was 0.44% in 2016 compared to 0.69% in 2015.

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

During 2016, the Company recorded a decrease in net interest and dividend income of \$1,169, due primarily to a decrease in the yield on earning assets of 18 basis points as well as a decrease in average earning assets as both investment and loan average balances decreased. During 2016, interest and dividend income decreased \$2,365. Average loan balances decreased \$21,564 while the yield on loans decreased 16 basis points, resulting in a decrease in interest and dividend income on loans of \$1,839. Interest and dividend income on cash and investments, net, decreased \$526 as a result of a decrease in average investments of \$10,700 and a decrease in yield of 25 basis points partially offset by an increase in average cash of \$4,498 and an increase in yield

2016 OVERVIEW (CONTINUED)

of 24 basis points. Interest expense decreased \$1,196. Interest expense on borrowed funds decreased \$597 as a result of a decrease in average borrowings of \$20,045. Interest expense on deposits decreased \$599 due primarily to a decrease in the rate paid of 8 basis points. During 2016, average certificates of deposit balances decreased \$36,737 due to a designed effort to reduce excess liquidity. These funds were at an average rate of 1.45%. These balances were replaced with lower costing savings and NOW balances.

Based on the continued improvement of the credit quality of our loan portfolio and other factors relevant to the adequacy of our allowance for loan losses, there was no provision for loan losses for the years ended December 31, 2016 and 2015. The allowance for loan losses as a percentage of nonperforming loans increased to 236% at December 31, 2016 compared to 129% at December 31, 2015. Nonperforming loans as a percentage of total loans decreased to 0.60% as of December 31, 2016 compared to 1.18% as of December 31, 2015.

Noninterest income, excluding net gain on sales of loans and net securities gains, increased \$835 thousand compared to the same period in 2015 as the cash surrender value of life insurance gain increased \$292 thousand and other noninterest income for 2016 included \$379 thousand of interest rate swap fee income partially offset by a decrease in service charge revenue which has been negatively impacted by regulatory changes. Net gains on sales of securities were \$2,661 in 2016, compared to \$3,067 in 2015. Noninterest expense increased \$3,284 in 2016 due primarily to the recognition of \$3,077 in expense related to the termination of the defined benefit plan and the recognition of a prepayment fee on the prepayment of \$33,000 in Federal Home Loan Bank of Boston ("FHLBB") long-term advances of \$993 partially offset by lower marketing expense, Federal Deposit Insurance Corporation ("FDIC") insurance expense, and management recruitment expense.

Total assets decreased \$44,006, or 4.7%, to \$889,598 at December 31, 2016 compared to \$933,604 at December 31, 2015. The following is a summary of notable balance sheet changes.

	(\$000 Omitted)			
	December 31			
	2016	2015	Change	
			Amount	%
Total assets	\$ 889,598	\$ 933,604	\$ (44,006)	-4.7
Earning assets	851,292	895,682	(44,390)	-5.0
Securities available-for-sale, at fair value	261,008	254,476	6,532	2.6
Interest-bearing deposits	32,541	80,783	(48,242)	-59.7
Loans, net of unamortized cost/uneared income	553,472	555,922	(2,450)	-0.4
Deposits	737,732	757,922	(20,190)	-2.7
Borrowings	71,148	99,569	(28,421)	-28.5
Shareholders' equity	74,403	70,307	4,096	5.8

Interest-bearing deposits decreased \$48,242. During 2016, the Company used a portion of this excess liquidity to prepay \$33,000 in FHLBB long-term advances at an average cost of 4.11%. Securities available-for-sale increased \$6,532 and loans, net of unamortized cost/uneared income decreased \$2,450. Net funding decreased \$48,611 as deposits decreased \$20,190 due primarily to the decrease in certificates of deposit partially offset by increases in savings and NOW balances. Borrowings decreased \$28,421 as the prepayment of \$33,000 in FHLBB long-term advances was partially offset by an increase in securities sold under agreements to repurchase. Shareholders' equity increased \$4,096 due primarily to the recording of net income for the year ended December 31, 2016 of \$4,015 and a decrease in accumulated other comprehensive loss of \$1,842, partially offset by dividends declared and paid to common shareholders of \$1,761.

CONSOLIDATED STATEMENTS OF INCOME

FOR THE YEARS ENDED DECEMBER 31,	(\$000 Omitted, except per share data)	
	2016	2015
Interest and dividend income		
Interest and fees on loans	\$ 24,237	\$ 26,076
Interest on debt securities available-for-sale		
Taxable	4,526	4,831
Tax-exempt	900	1,328
Dividends	554	491
Interest on interest-bearing deposits	290	146
Total interest and dividend income	30,507	32,872
Interest expense		
Interest on deposits	3,247	3,846
Interest on short-term borrowings	66	47
Interest on long-term debt	1,283	1,899
Total interest expense	4,596	5,792
Net interest and dividend income	25,911	27,080
Provision for loan losses	-	-
Net interest and dividend income after provision for loan losses	25,911	27,080
Noninterest income		
Service charges and fees on deposit accounts	1,756	1,970
Debit card fees	1,514	1,523
Gain on sales and calls of securities available-for-sale, net	2,661	3,067
Commission on alternative investments	524	436
Other	1,897	907
Total noninterest income	8,352	7,903
Noninterest expense		
Salaries and employee benefits	17,788	15,184
Office occupancy and equipment	3,434	3,264
Amortization of core deposit intangibles	50	62
Other	8,030	7,508
Total noninterest expense	29,302	26,018
Income before income tax expense	4,961	8,965
Income tax expense	946	2,480
Net income	\$ 4,015	\$ 6,485
Net income available to common shareholders	\$ 4,015	\$ 6,212
Basic earnings per common share	\$ 1.46	\$ 2.26
Earnings per common share assuming dilution	\$ 1.46	\$ 2.26

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE YEARS ENDED DECEMBER 31,	(\$000 Omitted)	
	2016	2015
Net income	\$ 4,015	\$ 6,485
Other comprehensive income/(loss)		
Net unrealized gains/(losses) on securities available-for-sale	1,125	(1,239)
Reclassification adjustment for realized gains in net income	(2,661)	(3,067)
Net unrealized losses on securities	(1,536)	(4,306)
Pension valuation adjustment (see Note 14)	3,945	1,857
Pension prior service credit adjustment (see Note 14)	-	(34)
Recognized curtailment loss-pension plan (see Note 14)	-	(2)
Interest rate swap valuation	638	-
Investment in limited partnership valuation adjustment	3	(9)
Other comprehensive income/(loss)	3,050	(2,494)
Income tax (provision)/benefit	(1,208)	988
Other comprehensive income/(loss), net of tax	1,842	(1,506)
Comprehensive income	\$ 5,857	\$ 4,979

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

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31,	(\$000 Omitted)	
	2016	2015
Assets		
Cash and cash equivalents		
Cash and due from banks and interest-bearing deposits	\$ 43,204	\$ 91,479
Total cash and cash equivalents	43,204	91,479
Restricted cash	1,650	-
Interest-bearing time deposits with other banks	-	248
Securities available-for-sale, at fair value	261,008	254,476
Federal Home Loan Bank of Boston stock	1,398	3,158
Loans held-for-sale	242	249
Loans, net before allowance for loan losses	553,472	555,922
Less: allowance for loan losses	7,878	8,623
Net loans	545,594	547,299
Premises and equipment, net	12,796	12,893
Other real estate owned	118	463
Goodwill	9,934	9,934
Core deposit intangibles, net	82	132
Other assets	13,572	13,273
Total assets	\$ 889,598	\$ 933,604
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Demand	\$ 126,488	\$ 115,672
Regular savings, NOW and money market deposit accounts	454,292	432,473
Certificates of deposit (in denominations of \$250 or more)	11,923	16,660
Other time	145,029	193,117
Total deposits	737,732	757,922
Short-term borrowings	50,528	44,042
Long-term debt	20,620	55,527
Other liabilities	6,315	5,806
Total liabilities	815,195	863,297
Shareholders' equity		
Common stock, \$1.00 par value; 9,000 shares authorized; 3,800 shares issued and 2,752 outstanding at December 31, 2016 and December 31, 2015	3,800	3,800
Additional paid-in-capital	4,140	4,140
Retained earnings	83,143	80,889
Treasury stock, 1,049 shares at December 31, 2016 and December 31, 2015	(15,470)	(15,470)
Accumulated other comprehensive loss, net of tax	(1,210)	(3,052)
Total shareholders' equity	74,403	70,307
Total liabilities and shareholders' equity	\$ 889,598	\$ 933,604

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(\$000 Omitted)

	Preferred Stock Series C	Common Stock	Additional Paid-in- Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance at December 31, 2014	\$ 24	\$ 3,800	\$ 27,672	\$76,438	\$(15,470)	\$ (1,546)	\$ 90,918
Net income - 2015	-	-	-	6,485	-	-	6,485
Preferred stock accretion (amortization)	-	-	37	(37)	-	-	-
Redemption of preferred stock	(24)	-	(23,569)	-	-	-	(23,593)
Net change in accumulated other comprehensive loss, net of taxes	-	-	-	-	-	(1,506)	(1,506)
Cash dividend declared on preferred stock Series C	-	-	-	(236)	-	-	(236)
Cash dividends declared on common stock (\$0.64 per share)	-	-	-	(1,761)	-	-	(1,761)
Balance at December 31, 2015	\$ -	\$ 3,800	\$ 4,140	\$80,889	\$(15,470)	\$ (3,052)	\$ 70,307
Net income - 2016	-	-	-	4,015	-	-	4,015
Net change in accumulated other comprehensive loss, net of taxes	-	-	-	-	-	1,842	1,842
Cash dividends declared on common stock (\$0.64 per share)	-	-	-	(1,761)	-	-	(1,761)
Balance at December 31, 2016	\$ -	\$ 3,800	\$ 4,140	\$83,143	\$(15,470)	\$ (1,210)	\$ 74,403

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

	(\$000 Omitted)	
	2016	2015
Net unrealized holding losses on available-for-sale securities	\$ (1,588)	\$ (661)
Net unrealized loss on pension valuation	-	(2,382)
Net loss on investment in a limited partnership	(7)	(9)
Net unrealized gain on interest rate swap	385	-
	<u>\$ (1,210)</u>	<u>\$ (3,052)</u>

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31,	(\$000 Omitted)	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 4,015	\$ 6,485
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,304	1,331
Deferred income tax (benefit)/expense	(228)	658
Pension plan termination loss	3,077	-
Gain on sales and calls of securities available-for-sale, net	(2,661)	(3,067)
Write-down of other real estate owned	42	137
Loss on sale, disposal and write-down of premises and equipment	43	30
Amortization of premiums and accretion of discounts on securities available-for-sale, net	1,295	1,420
Amortization of deferred prepayment penalty on FHLBB advances	93	93
Change in unearned income/unamortized cost, net	(15)	(117)
Loss on sale of former bank premises	-	153
(Gain) loss on sales of other real estate owned and other chattels, net	(5)	37
Net decrease in loans held-for-sale	7	184
Net change in other assets and other liabilities	592	(235)
Net cash provided by operating activities	7,559	7,109
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	70,933	79,727
Proceeds from maturities and calls of securities available-for-sale	50,499	27,614
Purchase of securities available-for-sale	(128,134)	(142,829)
Redemption of FHLBB stock	1,760	781
Redemption of interest-bearing time deposits	248	-
Loan originations and principal collections, net	8,354	51,601
Purchase of loans, net of principal collections	(7,009)	(4,817)
Recoveries of previously charged-off loans	329	400
Proceeds from sale of former bank premises	-	429
Proceeds from sales of and payments received on other real estate owned	405	340
Additions to premises and equipment and software, net of disposals	(1,100)	(156)
Net cash (used)/provided by investing activities	(3,715)	13,090
Cash flows from financing activities:		
Net (decrease)/increase in deposits	(20,190)	31,292
Net increase in short-term borrowings	6,486	9,192
Repayment of FHLBB advances	(35,000)	(10,000)
Redemption of preferred stock	-	(23,593)
Cash dividends paid	(1,761)	(2,056)
Net increase in restricted cash received for interest rate swap collateral	(1,650)	-
Cash paid for pension plan termination	(4)	-
Net cash (used)/provided by financing activities	(52,119)	4,835
Net (decrease)/increase in cash and cash equivalents	(48,275)	25,034
Cash and cash equivalents at beginning of year	91,479	66,445
Cash and cash equivalents at end of year	\$ 43,204	\$ 91,479

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

FOR THE YEARS ENDED DECEMBER 31,	(\$000 Omitted)	
	2016	2015
<hr/>		
Supplemental disclosure of cash flow information:		
Interest paid	\$ 4,755	\$ 5,815
Taxes paid	1,011	2,465
Non-cash investing and financing activities:		
Loans transferred to other real estate owned	177	384
See Notes to Consolidated Financial Statements		

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

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

Basis of Presentation

The consolidated financial statements include the accounts of Northway and the Bank. All significant intercompany accounts and transactions have been eliminated in the consolidation. All amounts presented have been rounded to the nearest thousands, except per share amounts.

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

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

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

Reclassifications

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

Cash and Cash Equivalents

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

Restricted Cash

The Company holds restricted cash as collateral for an interest rate swap. See Note 17 “On-Balance Sheet Derivative Instruments and Hedging Activities”.

Securities

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

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

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

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

Federal Home Loan Bank of Boston ("FHLBB") stock is carried at cost and can only be sold to the FHLBB based on its current redemption policies. Management evaluates the Company's investment in FHLBB stock for other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such calculations. Based on its most recent analysis of the FHLBB as of December 31, 2016, management deems its investment in FHLBB stock to be not other-than-temporarily impaired.

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

Loans Held-for-Sale

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

Loans

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

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

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

Occasionally the Company will enter into an agreement to change the terms of an underlying loan from fixed to variable pricing or vice versa. The impact of these agreements has been deemed immaterial to the financial statements.

Allowance for Loan Losses

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

The allowance for loan losses is evaluated on a regular basis by management. This evaluation is inherently subjective as it requires

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses consists of general, allocated and unallocated components, as further described below.

General component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following loan segments: residential real estate, residential construction, commercial real estate, commercial real estate construction, commercial, municipal and consumer. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company's policies pertaining to the general component of the allowance for loan losses during 2016. During 2016, the pooling of loans methodology was modified to align with the Call Report codes and to follow industry best practices. Methodology enhancements related to qualitative factors were refined in the third quarter of 2015, the result of which is a more robust analysis based on historic trends. This change impacted all pools, and the qualitative factors continue to be reviewed quarterly.

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

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

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

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

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

Consumer loans - Loans in this segment are comprised primarily of secured loans, including automobile loans, and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this segment.

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

Allocated component

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

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

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

Unallocated component

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

Premises and Equipment

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

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

Other Real Estate Owned

Other real estate owned is comprised of properties acquired either through foreclosure proceedings or acceptance of a deed in lieu of foreclosure, as well as former banking premises for which banking use is no longer contemplated. If the Company receives physical possession of the debtor's assets prior to obtaining a deed in lieu of foreclosure or the occurrence of foreclosure proceedings, the Company reclassifies the loan to other real estate owned in substance.

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

Advertising

The Company directly expenses costs associated with advertising as they are incurred. For the years ended December 31, 2016 and 2015, respectively, the Company incurred \$180 and \$283 in advertising expenses.

Income Taxes

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and the respective tax bases and operating loss and tax credit carry forwards.

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Company recognizes interest and penalties, if any, related to the underpayment of income taxes in income tax expense.

Earnings Per Share

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

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

	Years Ended December 31,	
	2016	2015
Net income	\$ 4,015	\$ 6,485
Preferred stock net accretion	-	(37)
Preferred stock dividends	-	(236)
Net income available to common shareholders	<u>\$ 4,015</u>	<u>\$ 6,212</u>
Average number of common shares outstanding	<u>2,751.7</u>	<u>2,751.7</u>
Effect of dilutive options	-	-
Average number of common shares outstanding used to calculate diluted earnings per common share	<u>2,751.7</u>	<u>2,751.7</u>

Derivative Financial Instruments

Derivative financial instruments are recognized as assets and liabilities on the consolidated balance sheets and measured at fair value, if material.

The Company enters into interest rate swap agreements with commercial loan customers to effectively convert a customer's loan from a variable rate to a fixed rate. These swaps are matched in offsetting terms to swaps that the Company enters into with an outside counterparties, which effectively converts the Bank loans from fixed rate to variable rate. The swaps are classified within other assets and other liabilities in the consolidated balance sheet with changes in fair value offsetting each other.

The Company uses interest rate swap agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts. Such derivatives are used as part of the asset/liability management process and are linked to specific assets or liabilities, and have high correlation between the contract and the underlying item being hedged, both at inception and throughout the hedge period.

The Company utilizes interest rate swap arrangements to convert a portion of its variable-rate debt to a fixed rate (cash flow hedge). Interest rate swaps are contracts in which a series of interest rate flows are exchanged over a prescribed period. The notional amount on which the interest payments are based is not exchanged.

Under ASC 815, "Derivatives and Hedging", the gain or loss on a derivative designated and qualifying as a fair value hedging instrument, as well as the offsetting gain or loss on the hedged item attributable to the risk being hedged, is recognized currently in earnings in the same accounting period. The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized currently in earnings.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Company to risk. Those derivative financial instruments that do not meet the hedging criteria discussed below would be classified as trading activities and would be recorded at fair value with changes in fair value recorded in income. Derivative hedge contracts must meet specific effectiveness tests (i.e., over time the change in their fair values due to the designated hedge risk must be within 80 to 125 % of the opposite change in the fair values of the hedged assets or liabilities). Changes in fair value of the derivative financial instruments must be effective at offsetting changes in the fair value of the hedged items due to the

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

designated hedge risk during the term of the hedge. Further, if the underlying financial instrument differs from the hedged asset or liability, there must be a clear economic relationship between the prices of the two financial instruments. If periodic assessment indicates derivatives no longer provide an effective hedge, the derivatives contracts would be closed out and settled or classified as a trading activity.

In accordance with ASC 815, hedges of variable-rate debt are accounted for as cash flow hedges, with changes in fair value recorded in derivative assets or liabilities and other comprehensive income. The net settlement (upon close out or termination) that offsets changes in the value of the hedged debt is deferred and amortized into net interest income over the life of the hedged debt. The portion, if any, of the net settlement amount that did not offset changes in the value of the hedged asset or liability is recognized immediately in non-interest income.

Cash flows resulting from the derivative financial instruments that are accounted for as hedges of assets and liabilities are classified in the cash flow statement in the same category as the cash flows of the items being hedged.

Preferred Stock

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

On December 31, 2015, the Company redeemed all of the 23,593 outstanding shares of the Company's Senior Non-cumulative Perpetual Preferred Stock, Series C, liquidation amount \$1,000 per share, that had been issued to the United States Department of the Treasury in September 2011 pursuant to the SBLF program. The aggregate redemption price of the preferred stock was \$23,652, including dividends accrued but unpaid through, but not including, the redemption date.

Recent Accounting Pronouncements

In May 2014 and August 2015, respectively, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09 and 2015-14, "Revenue from Contracts with Customers (Topic 606)". The objective of ASU 2014-09 is to clarify principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards. The guidance in ASU 2014-09 affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is currently reviewing ASUs 2014-09 and 2015-14 to determine if they will have an impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities". The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and make targeted improvements to GAAP as follows:

Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.

Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value.

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.

Require an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

The amendments in this Update are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early application of certain of the pending content is permitted for financial statements of fiscal years or interim periods that have not yet been issued. The Company is currently reviewing this ASU to determine if it will have an impact on its consolidated financial statements. Refer to Note 2, "Securities Available-for-Sale", for information pertaining to equity securities held by the Company as of the periods presented.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)". This update to existing GAAP is to recognize lease assets and lease liabilities for those leases currently classified as operating leases, unless the lease term is 12 months or less. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently reviewing this ASU to determine if it will have a material impact on its consolidated financial statements. Refer to Note 15 of the notes to the consolidated financial statements for information pertaining to non-cancelable leases under which the Company is obligated.

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments". The amendments in this ASU require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions will now use forward-looking information to better inform their credit loss estimates.

Many of the loss estimation techniques applied currently will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early application will be permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently reviewing this ASU to determine the impact on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230) – Classification of Certain Cash Receipts and Cash Payments". These amendments include cash flow statement classification guidance for:

- Debt Prepayment or Debt Extinguishment Costs;
- Proceeds from the Settlement of Insurance Claims;
- Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, including Bank-Owned, and
- Separately Identifiable Cash Flows and Application of the Predominance Principle.

This update is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early application is permitted, including adoption in an interim period. The Company is currently reviewing this ASU to determine if it will have an impact on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230)". These amendments require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. As a result, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

end-of-period total amounts shown on the statement of cash flows. The amendments do not provide a definition of restricted cash or restricted cash equivalents. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The amendments should be applied using a retrospective transition method to each period presented. The Company does not anticipate the impact to be significant.

In January 2017, the FASB issued ASU 2017-03, "Accounting Changes and Error Corrections (Topic 250) and Investments – Equity Method and Joint Ventures (Topic 323)". These amendments apply to ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)", ASU 2016-02, "Leases (Topic 842)" and ASU 2016-13, "Financial Instruments – Credit Losses (Topic 626): Measurement of Credit Losses on Financial Instruments". In evaluating the effects of these updates on the financial statements when adopted, if the Company does not know or cannot reasonably estimate the impact that adoption of the ASU is expected to have on the financial statements, then in addition to making a statement to that effect, the Company should consider additional qualitative financial statement disclosures. This update is effective for years beginning after December 15, 2020, including interim periods within those fiscal years. Early application is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

NOTE 2 SECURITIES AVAILABLE-FOR-SALE

The amortized cost basis, gross unrealized gains, gross unrealized losses, and fair value of securities at December 31, 2016 and 2015 follow:

	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>December 31, 2016</u>				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 27,478	\$ 23	\$ 406	\$ 27,095
U.S. government agency and sponsored enterprise mortgage-backed securities	109,404	25	1,465	107,964
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	52,191	297	296	52,192
State and political subdivision bonds	55,798	211	1,629	54,380
Marketable equity securities	18,767	1,424	814	19,377
	<u>\$ 263,638</u>	<u>\$ 1,980</u>	<u>\$ 4,610</u>	<u>\$ 261,008</u>
<u>December 31, 2015</u>				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 38,973	\$ 116	\$ 515	\$ 38,574
U.S. government agency and sponsored enterprise mortgage-backed securities	121,077	68	1,012	120,133
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	40,744	185	54	40,875
State and political subdivision bonds	40,791	791	93	41,489
Marketable equity securities	13,985	630	1,210	13,405
	<u>\$ 255,570</u>	<u>\$ 1,790</u>	<u>\$ 2,884</u>	<u>\$ 254,476</u>

NOTE 2 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

The contractual maturity distribution of investments in debt obligations at December 31, 2016 follows:

	<u>Within One Year</u>	<u>Over One Through Five Years</u>	<u>After Five Through Ten Years</u>	<u>Over Ten Years</u>	<u>Total Amortized Cost</u>
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ -	\$ -	\$ 7,975	\$ 19,503	\$ 27,478
U.S. government agency and sponsored enterprise mortgage-backed securities	-	-	2,513	106,891	109,404
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	-	704	4,796	46,691	52,191
State and political subdivision bonds	-	-	3,040	52,758	55,798
Total amortized cost	<u>\$ -</u>	<u>\$ 704</u>	<u>\$ 18,324</u>	<u>\$ 225,843</u>	<u>\$ 244,871</u>
Fair value	<u>\$ -</u>	<u>\$ 698</u>	<u>\$ 18,233</u>	<u>\$ 222,700</u>	<u>\$ 241,631</u>

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

For the years ended December 31, 2016 and 2015, gross proceeds from the sales of securities available-for-sale amounted to \$70,933 and \$79,727, respectively. An analysis of gross realized gains and losses on sales of securities available-for-sale during the years ended December 31, follows:

	<u>2016</u>		<u>2015</u>	
	<u>Realized Gains</u>	<u>Realized Losses</u>	<u>Realized Gains</u>	<u>Realized Losses</u>
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 539	\$ -	\$ 472	\$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	891	-	603	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	-	-	155	-
State and political subdivision bonds	375	-	974	-
Marketable equity securities	1,036	233	865	71
	<u>\$ 2,841</u>	<u>\$ 233</u>	<u>\$ 3,069</u>	<u>\$ 71</u>

The tax provision applicable to these net realized gains amounted to \$1,033 and \$1,188 for 2016 and 2015, respectively.

Securities with a carrying amount totaling \$199,583 and \$191,774 were pledged to secure public deposits and securities sold under agreements to repurchase at December 31, 2016 and 2015, respectively.

NOTE 2 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

The aggregate fair value and unrealized losses of securities that have been in a continuous unrealized loss position for less than twelve months and for twelve months or more are as follows as of December 31:

	<u>Less than 12 Months</u>		<u>12 Months or Longer</u>		<u>Total</u>	
	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>	<u>Fair</u>	<u>Unrealized</u>
	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>	<u>Value</u>	<u>Losses</u>
<u>December 31, 2016</u>						
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 22,071	\$ 406	\$ -	\$ -	\$ 22,071	\$ 406
U.S. government agency and sponsored enterprise mortgage-backed securities	102,270	1,465	-	-	102,270	1,465
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	28,710	296	-	-	28,710	296
State and political subdivision bonds	35,983	1,616	531	13	36,514	1,629
Marketable equity securities	4,750	311	2,932	503	7,682	814
Total temporarily impaired securities	<u>\$ 193,784</u>	<u>\$ 4,094</u>	<u>\$ 3,463</u>	<u>\$ 516</u>	<u>\$ 197,247</u>	<u>\$ 4,610</u>
<u>December 31, 2015</u>						
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 26,255	\$ 515	\$ -	\$ -	\$ 26,255	\$ 515
U.S. government agency and sponsored enterprise mortgage-backed securities	96,455	1,012	-	-	96,455	1,012
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	9,087	46	757	8	9,844	54
State and political subdivision bonds	4,139	65	1,447	28	5,586	93
Marketable equity securities	4,880	494	2,308	716	7,188	1,210
Total temporarily impaired securities	<u>\$ 140,816</u>	<u>\$ 2,132</u>	<u>\$ 4,512</u>	<u>\$ 752</u>	<u>\$ 145,328</u>	<u>\$ 2,884</u>

At December 31, 2016, securities with a total fair value of \$197,247 were in a loss position. These securities included five U.S. government agency securities with a fair value of \$22,071 and an unrealized loss of \$406 at December 31, 2016. These securities had an unrealized loss due to the current interest rate environment. As these securities are guaranteed by Federal Farm Credit Bank (“FFCB”), Federal Home Loan Mortgage Corporation (“FHLMC”), and Federal National Mortgage Association (“FNMA”), there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Thirty-six U.S. government agency and sponsored enterprise mortgage-backed securities with a fair value of \$102,270 had an unrealized loss of \$1,465 at December 31, 2016. These securities had a loss due to the current interest rate environment. As these securities are guaranteed by U.S. government agencies or government-sponsored enterprises such as the FHLMC, FNMA or the Government National Mortgage Association, there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Thirteen collateralized mortgage obligations with a fair value of \$28,710 had an unrealized loss of \$296 at December 31, 2016. These securities had an unrealized loss due to the current interest rate environment. As these collateralized mortgage obligations are government-sponsored enterprise bonds issued by the Small Business Investment Conduit, the Small Business Administration Participation Certificates, or FNMA there is little or no credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability and intent to hold them until cost recovery.

Fifty-seven state and political subdivision securities with a fair value of \$36,514 had an unrealized loss of \$1,629 at December 31, 2016. All of these state and political subdivision securities are guaranteed by municipalities and there is minimal credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability and intent to hold them until cost recovery.

Seventy-one marketable equity securities with a fair value of \$7,682 had an unrealized loss of \$814 at December 31, 2016. Marketable equity securities are subject to internal testing on a quarterly basis to determine impairment. Testing includes review of industry analyst reports, credit ratings, sector analysis and earnings projections. Based upon the December 31, 2016 review, these securities have been classified as not other-than-temporarily impaired.

NOTE 3 LOANS

Loan balances were comprised of the following:

<u>December 31,</u>	<u>2016</u>	<u>2015</u>
Real estate:		
Residential	\$ 208,080	\$ 206,980
Commercial	234,941	216,054
Construction	5,394	20,121
Commercial	62,412	70,168
Consumer	8,182	7,714
Municipal	34,303	34,740
Total loans	<u>553,312</u>	<u>555,777</u>
Unamortized costs	160	145
Allowance for loan losses	<u>(7,878)</u>	<u>(8,623)</u>
Total unamortized costs and allowance for loan losses	<u>(7,718)</u>	<u>(8,478)</u>
Net loans	<u>\$ 545,594</u>	<u>\$ 547,299</u>

Loans are made in the ordinary course of business to directors, executive officers, and their immediate families and to organizations in which such persons have more than a 10% ownership interest. These loans are made on substantially the same terms, including interest rate and collateral, as those prevailing at the same time for comparable transactions with unrelated persons and did not involve more than the normal risk of collectability or present other unfavorable features. There were no such loans as of December 31, 2016. During 2016, change in status resulted in a decrease in balances of \$297 and principal payments amounted to \$13.

The Company's lending activities are conducted principally in New Hampshire. Although the loan portfolio is diversified, a portion of its debtors' ability to repay is dependent upon the economic conditions prevailing in New Hampshire. The Company maintains significant credit relationships with borrowers in the hotel and motel industry. The aggregate loan balances to these industries totaled \$64,430 and \$67,617 at December 31, 2016 and 2015, respectively.

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans total \$72,783 and \$65,006 at December 31, 2016 and 2015, respectively. The Company sold \$4,798 of mortgage loans in 2016 and \$4,936 of mortgage loans in 2015.

There were no loans 90 days or more past due and still accruing interest at December 31, 2016 and 2015. The following tables are an aging analysis of the recorded investment in past due loans and nonaccrual loans as of December 31, 2016 and 2015.

<u>Aging Analysis of Past Due Loans</u>					
<u>December 31, 2016</u>	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>90 Days or More</u>	<u>Total Past Due</u>	<u>Nonaccrual Loans</u>
Real estate:					
Residential	\$ 735	\$ 194	\$ 665	\$ 1,594	\$ 1,448
Commercial	130	266	355	751	1,431
Construction	-	-	-	-	-
Commercial	169	-	93	262	436
Consumer	41	25	9	75	23
Total	<u>\$ 1,075</u>	<u>\$ 485</u>	<u>\$ 1,122</u>	<u>\$ 2,682</u>	<u>\$ 3,338</u>
<u>December 31, 2015</u>	<u>30-59 Days</u>	<u>60-89 Days</u>	<u>90 Days or More</u>	<u>Total Past Due</u>	<u>Nonaccrual Loans</u>
Real estate:					
Residential	\$ 1,644	\$ 108	\$ 353	\$ 2,105	\$ 2,390
Commercial	1,124	69	1,990	3,183	3,262
Construction	218	-	-	218	7
Commercial	56	-	466	522	1,007
Consumer	200	13	45	258	28
Total	<u>\$ 3,242</u>	<u>\$ 190</u>	<u>\$ 2,854</u>	<u>\$ 6,286</u>	<u>\$ 6,694</u>

NOTE 3 LOANS (CONTINUED)

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>December 31, 2016</u>					
With no related allowance recorded:					
Real estate:					
Residential	\$ 1,321	\$ 1,388	\$ -	\$ 1,438	\$ 16
Commercial	953	1,431	-	3,105	49
Construction	736	736	-	746	-
Commercial	296	387	-	676	16
Consumer	-	-	-	11	-
Total impaired with no related allowance	<u>3,306</u>	<u>3,942</u>	<u>-</u>	<u>5,976</u>	<u>81</u>
With an allowance recorded:					
Real estate:					
Residential	\$ 178	\$ 178	\$ 6	\$ 43	\$ 7
Commercial	2,232	2,321	344	2,472	18
Commercial	1,188	1,189	134	789	10
Consumer	17	19	13	6	1
Total impaired with an allowance recorded	<u>3,615</u>	<u>3,707</u>	<u>497</u>	<u>3,310</u>	<u>36</u>
Total:					
Real estate:					
Residential	1,499	1,566	6	1,481	23
Commercial	3,185	3,752	344	5,577	67
Construction	736	736	-	746	-
Commercial	1,484	1,576	134	1,465	26
Consumer	17	19	13	17	1
Total impaired loans	<u>\$ 6,921</u>	<u>\$ 7,649</u>	<u>\$ 497</u>	<u>\$ 9,286</u>	<u>\$ 117</u>
<u>December 31, 2015</u>					
With no related allowance recorded:					
Real estate:					
Residential	\$ 985	\$ 1,053	\$ -	\$ 843	\$ 47
Commercial	4,593	5,557	-	4,641	246
Commercial	732	810	-	879	33
Total impaired with no related allowance	<u>6,310</u>	<u>7,420</u>	<u>-</u>	<u>6,363</u>	<u>326</u>
With an allowance recorded:					
Real estate:					
Residential	\$ 881	\$ 884	\$ 261	\$ 703	\$ 39
Commercial	1,496	1,536	577	1,536	55
Commercial	729	737	482	605	31
Consumer	11	11	11	2	1
Total impaired with an allowance recorded	<u>3,117</u>	<u>3,168</u>	<u>1,331</u>	<u>2,846</u>	<u>126</u>
Total:					
Real estate:					
Residential	1,866	1,937	261	1,546	86
Commercial	6,089	7,093	577	6,177	301
Commercial	1,461	1,547	482	1,484	64
Consumer	11	11	11	2	1
Total impaired loans	<u>\$ 9,427</u>	<u>\$ 10,588</u>	<u>\$ 1,331</u>	<u>\$ 9,209</u>	<u>\$ 452</u>

NOTE 3 LOANS (CONTINUED)

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

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

2016					
Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment	Terms of Modification		
			Extended Maturity	Adjusted Interest Rate	Combination of Rate and Maturity
Troubled debt restructurings:					
Real estate:					
Residential	1	\$ 13	\$ -	\$ -	\$ 18
Commercial	7	1,230	-	-	1,234
Commercial	6	650	601	-	50
	<u>14</u>	<u>\$ 1,893</u>	<u>\$ 601</u>	<u>\$ -</u>	<u>\$ 1,302</u>

2016	
Number of Contracts	Recorded Investment
Troubled debt restructurings that subsequently defaulted:	
Troubled debt restructurings:	
Real estate:	
Residential	2 \$ 110
Commercial	2 310
Commercial	7 480
	<u>11 \$ 900</u>

2015					
Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post Modification Outstanding Recorded Investment	Terms of Modification		
			Extended Maturity	Adjusted Interest Rate	Combination of Rate and Maturity
Troubled debt restructurings:					
Real estate:					
Residential	1	\$ 233	\$ -	\$ 233	\$ -
Commercial	2	55	48	7	-
	<u>3</u>	<u>\$ 288</u>	<u>\$ 48</u>	<u>\$ 240</u>	<u>\$ -</u>

2015	
Number of Contracts	Recorded Investment
Troubled debt restructurings that subsequently defaulted:	
Troubled debt restructurings:	
Real estate:	
Residential	2 \$ 184
Commercial	4 1,208
Commercial	4 259
	<u>10 \$ 1,651</u>

NOTE 3 LOANS (CONTINUED)

During 2016, four TDR loans totaling \$126 were fully charged-off. During 2015, one TDR loan totaling \$333 was transferred to OREO after a \$147 charge-off. TDRs are individually evaluated for impairment. A specific allowance of \$386 and \$651 was established for TDR loans for the years ended December 31, 2016 and 2015, respectively. There were no commitments to lend additional funds to borrowers whose loans were modified in a troubled debt restructuring, as of December 31, 2016 and 2015.

NOTE 4 ALLOWANCE FOR LOAN LOSSES

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

	<u>Real Estate</u>							<u>Total</u>
	<u>Residential</u>	<u>Commercial</u>	<u>Construction</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Municipal</u>	<u>Unallocated</u>	
December 31, 2016								
Allowance for loans losses:								
Beginning balance	\$ 1,361	\$ 3,133	\$ 171	\$ 2,216	\$ 346	\$ 205	\$ 1,191	\$ 8,623
Charge-offs	(452)	(177)	-	(175)	(270)	-	-	(1,074)
Recoveries	1	38	-	197	93	-	-	329
Provision (benefit)	842	49	(129)	(1,005)	221	133	(111)	-
Ending balance	<u>\$ 1,752</u>	<u>\$ 3,043</u>	<u>\$ 42</u>	<u>\$ 1,233</u>	<u>\$ 390</u>	<u>\$ 338</u>	<u>\$ 1,080</u>	<u>\$ 7,878</u>
Ending balance: individually evaluated for impairment	<u>\$ 6</u>	<u>\$ 344</u>	<u>\$ -</u>	<u>\$ 134</u>	<u>\$ 13</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 497</u>
Ending balance: collectively evaluated for impairment	<u>\$ 1,746</u>	<u>\$ 2,699</u>	<u>\$ 42</u>	<u>\$ 1,099</u>	<u>\$ 377</u>	<u>\$ 338</u>	<u>\$ 1,080</u>	<u>\$ 7,381</u>
 Loans:								
Ending balance	<u>\$ 208,080</u>	<u>\$ 234,941</u>	<u>\$ 5,394</u>	<u>\$ 62,412</u>	<u>\$ 8,182</u>	<u>\$ 34,303</u>	<u>\$ -</u>	<u>\$ 553,312</u>
Ending balance: individually evaluated for impairment	<u>\$ 1,499</u>	<u>\$ 3,185</u>	<u>\$ 736</u>	<u>\$ 1,484</u>	<u>\$ 17</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 6,921</u>
Ending balance: collectively evaluated for impairment	<u>\$ 206,581</u>	<u>\$ 231,756</u>	<u>\$ 4,658</u>	<u>\$ 60,928</u>	<u>\$ 8,165</u>	<u>\$ 34,303</u>	<u>\$ -</u>	<u>\$ 546,391</u>
 December 31, 2015								
Allowance for loans losses:								
Beginning balance	\$ 1,141	\$ 3,514	\$ 286	\$ 3,051	\$ 314	\$ 100	\$ 400	\$ 8,806
Charge-offs	(78)	(147)	-	(65)	(293)	-	-	(583)
Recoveries	10	127	-	165	98	-	-	400
Provision (benefit)	288	(361)	(115)	(935)	227	105	791	-
Ending balance	<u>\$ 1,361</u>	<u>\$ 3,133</u>	<u>\$ 171</u>	<u>\$ 2,216</u>	<u>\$ 346</u>	<u>\$ 205</u>	<u>\$ 1,191</u>	<u>\$ 8,623</u>
Ending balance: individually evaluated for impairment	<u>\$ 261</u>	<u>\$ 577</u>	<u>\$ -</u>	<u>\$ 482</u>	<u>\$ 11</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,331</u>
Ending balance: collectively evaluated for impairment	<u>\$ 1,100</u>	<u>\$ 2,556</u>	<u>\$ 171</u>	<u>\$ 1,734</u>	<u>\$ 335</u>	<u>\$ 205</u>	<u>\$ 1,191</u>	<u>\$ 7,292</u>
 Loans:								
Ending balance	<u>\$ 206,980</u>	<u>\$ 216,054</u>	<u>\$ 20,121</u>	<u>\$ 70,168</u>	<u>\$ 7,714</u>	<u>\$ 34,740</u>	<u>\$ -</u>	<u>\$ 555,777</u>
Ending balance: individually evaluated for impairment	<u>\$ 1,866</u>	<u>\$ 6,089</u>	<u>\$ -</u>	<u>\$ 1,461</u>	<u>\$ 11</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 9,427</u>
Ending balance: collectively evaluated for impairment	<u>\$ 205,114</u>	<u>\$ 209,965</u>	<u>\$ 20,121</u>	<u>\$ 68,707</u>	<u>\$ 7,703</u>	<u>\$ 34,740</u>	<u>\$ -</u>	<u>\$ 546,350</u>

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

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

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

NOTE 4 ALLOWANCE FOR LOAN LOSSES (CONTINUED)

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

	Real Estate						Total
	Residential	Commercial	Construction	Commercial	Consumer	Municipal	
December 31, 2016							
Grade:							
Pass	\$ 166,003	\$ 212,746	\$ 4,658	\$ 54,711	\$ 3	\$ 259	\$ 438,380
Special mention	1,144	16,717	-	2,726	-	-	20,587
Substandard	1,472	5,444	736	4,932	1	-	12,585
Doubtful	159	34	-	43	18	-	254
Loss	-	-	-	-	-	-	-
Loans not formally rated	39,302	-	-	-	8,160	34,044	81,506
Total	<u>\$ 208,080</u>	<u>\$ 234,941</u>	<u>\$ 5,394</u>	<u>\$ 62,412</u>	<u>\$ 8,182</u>	<u>\$ 34,303</u>	<u>\$ 553,312</u>
December 31, 2015							
Grade:							
Pass	\$ 160,954	\$ 202,177	\$ 20,121	\$ 60,202	\$ 3	\$ 456	\$ 443,913
Special mention	1,230	4,586	-	4,401	-	-	10,217
Substandard	1,874	9,291	-	5,066	-	-	16,231
Doubtful	417	-	-	52	12	-	481
Loss	-	-	-	-	-	-	-
Loans not formally rated	42,505	-	-	447	7,699	34,284	84,935
Total	<u>\$ 206,980</u>	<u>\$ 216,054</u>	<u>\$ 20,121</u>	<u>\$ 70,168</u>	<u>\$ 7,714</u>	<u>\$ 34,740</u>	<u>\$ 555,777</u>

NOTE 5 PREMISES AND EQUIPMENT

A summary of premises and equipment follows:

	December 31,	
	2016	2015
Land	\$ 5,336	\$ 5,336
Buildings	12,201	12,201
Leasehold improvements	959	953
Equipment	7,618	7,334
	<u>26,114</u>	<u>25,824</u>
Less accumulated depreciation and amortization	13,318	12,931
	<u>\$ 12,796</u>	<u>\$ 12,893</u>

Depreciation expense for the years ended December 31, 2016 and 2015 amounted to \$1,045 and \$1,025, respectively.

NOTE 6 OTHER REAL ESTATE OWNED

Other real estate owned consists of real estate acquired by foreclosure or a similar conveyance of title, as well as former banking premises for which banking use is no longer contemplated. At December 31, 2016, other real estate owned of \$118 was comprised of former banking premises of \$87, and residential real estate of \$31. At December 31, 2015, other real estate owned of \$463 was comprised of commercial real estate of \$283, former banking premises of \$87 and residential real estate of \$93. At December 31, 2016 and 2015, the recorded investment in residential real estate loans in the process of foreclosure totaled \$402 and \$184, respectively. There were no assets held as other real estate owned in substance as of December 31, 2016.

Sales of other real estate owned by the Company resulted in gains of \$5 for the year ended December 31, 2016 and losses of \$190 for the year ended December 31, 2015. Write-downs of other real estate owned by the Company were \$42 and \$137 for the years ended December 31, 2016 and 2015, respectively.

NOTE 7 DEPOSITS

The aggregate amount of maturities for time deposits as of December 31, 2016 by year is as follows:

2017	\$	79,801
2018		27,017
2019		25,062
2020		17,602
2021		7,457
Thereafter		13
	\$	<u>156,952</u>

At December 31, 2016 and 2015, deposits acquired through a deposit listing service totaled \$8,977 and \$14,920, respectively. Deposit listing service account balances at or in excess of \$250 are reported as certificates of deposit in denominations of \$250 or more on the consolidated balance sheets.

Deposits from related parties held by the Bank at December 31, 2016 and 2015 amounted to \$3,684 and \$3,540, respectively.

NOTE 8 SHORT-TERM BORROWINGS

Short-term borrowings at December 31, 2016 and 2015 consisted of securities sold under agreements to repurchase of \$50,528 and \$44,042, respectively. Securities sold under agreements to repurchase were at a weighted average rate of 0.16% and 0.14% at December 31, 2016 and 2015, respectively. The securities sold under agreements to repurchase as of December 31, 2016 and 2015 are securities sold on a short-term basis by the Company that have been accounted for not as sales but as borrowings. The underlying securities associated with securities sold under agreements to repurchase are under the control of the Company. The purchasers have agreed to sell to the Company substantially identical securities at the maturity of the agreements.

NOTE 9 LONG-TERM DEBT

Long-term debt at December 31, 2016 and 2015 consisted of FHLBB advances of \$0 and \$34,907, respectively, as well as \$20,620 of junior subordinated debentures for each year.

As of December 31, 2016, contractual principal payments of \$20,620 for junior subordinated debentures are due in year 2037.

During 2016, the Company paid off the FHLBB long-term debt and recognized a prepayment penalty of \$993.

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

On March 22, 2007, the Company completed the private placement of \$10,310 aggregate liquidation amount of floating rate trust-preferred securities (the "Trust III Capital Securities") issued by Northway Capital Trust III ("Capital Trust III"). The Trust III Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust III Capital Securities, which included the proceeds from the sale by Capital Trust III of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the "Trust III Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated March 22, 2007 between the Company and Wilmington Trust Company as Trustee. Both the Trust III Capital Securities and the Trust III Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.60%. Currently, the interest rate on these securities is 2.56344%. Payments of distributions and other amounts due on the Trust III Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust III has funds available for the payments of such distributions, pursuant to a Guarantee Agreement, dated March 22, 2007, between the Company and Wilmington Trust Company, as Guarantee Trustee. The Trust III Junior Subordinated Debt and the Trust III Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on March 15, 2012.

On June 15, 2007, the Company completed the private placement of \$10,310 aggregate liquidation amount of floating rate trust-preferred securities (the "Trust IV Capital Securities") issued by Northway Capital IV ("Capital Trust IV"). The Trust IV Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust IV Capital Securities, which included the proceeds from the sale by the Capital Trust IV of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the "Trust IV Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated June 15, 2007 between the Company and Wells Fargo Bank, National Association, as Trustee.

NOTE 9 LONG-TERM DEBT (CONTINUED)

Both the Trust IV Capital Securities and the Trust IV Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.49%. Currently, the interest rate on these securities is 2.45344%. Payments of distributions and other amounts due on the Trust IV Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust IV has funds available from the payments of such distributions, pursuant to a Guarantee Agreement, dated June 15, 2007, between the Company and Wells Fargo Bank, National Association, as Guarantee Trustee. The Trust IV Junior Subordinated Debt and the Trust IV Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on June 15, 2012.

On September 15, 2016, the Company entered into an interest rate swap agreement with a counterparty to convert the floating rate payments on Trust III Capital Securities to fixed rate payments. The terms of the interest rate swap agreement are as follows:

Notional amount	\$10,000
Trade date	August 10, 2016
Effective date	September 15, 2016
Termination date	September 15, 2021
Fixed rate payer	Northway Financial, Inc.
Payment dates	Quarterly
Fixed rate	2.745%
Floating rate payer	PNC Bank, N.A.
Payment dates	Quarterly
Index	Three month LIBOR plus 1.20%

On September 15, 2016, the Company entered into an interest rate swap agreement with a counterparty to convert the floating rate payments on Trust IV Capital Securities to fixed rate payments. The terms of the interest rate swap agreement are as follows:

Notional amount	\$10,000
Trade date	August 10, 2016
Effective date	September 15, 2016
Termination date	September 15, 2021
Fixed rate payer	Northway Financial, Inc.
Payment dates	Quarterly
Fixed rate	2.745%
Floating rate payer	PNC Bank, N.A.
Payment dates	Quarterly
Index	Three month LIBOR plus 1.20%

NOTE 10 GOODWILL AND OTHER INTANGIBLE ASSETS

At December 31, 2016, the Company has goodwill and core deposit intangibles totaling \$10,016. Core deposit intangibles are being amortized over their estimated useful lives, and both core deposit intangibles and goodwill are tested for impairment at least annually.

The changes in the carrying amount of goodwill and core deposit intangibles for the years ended December 31, 2016 and 2015 are as follows:

	<u>Goodwill</u>	<u>Core Deposit Intangibles</u>
Balance, December 31, 2014	\$ 9,934	\$ 194
Amortization expense	-	(62)
Balance, December 31, 2015	9,934	132
Amortization expense	-	(50)
Balance, December 31, 2016	<u>\$ 9,934</u>	<u>\$ 82</u>

Estimated annual amortization expense of the core deposit intangible is as follows:

2017	\$ 38
2018	26
2019	15
2020	3

The following table reflects the gross carrying amount and accumulated amortization of core deposit intangibles as of December 31, 2016:

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Amount</u>
Core deposit intangibles	<u>\$ 3,927</u>	<u>\$ 3,845</u>	<u>\$ 82</u>

Management reviews the carrying amount of intangible assets on an ongoing basis, taking into consideration any events and circumstances that may indicate the carrying value may not be recoverable. During 2016 and 2015, the Company reviewed the carrying amount of intangible assets and determined that no impairment write-down was required.

NOTE 11 REGULATORY MATTERS

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

Effective January 1, 2015 (with a phase-in period of two to four years for certain components), the Bank became subject to new capital regulations adopted by the Board of Governors of the Federal Reserve System and the FDIC, which implement the Basel III regulatory capital reforms and the changes required by the Dodd-Frank Act. The new regulations require a new common equity Tier 1 ("CET1") capital ratio of 4.5%, increase the minimum Tier 1 capital to risk-weighted assets ratio to 6.0% from 4.0%, require a minimum total capital to risk-weighted assets ratio of 8.0% and require a minimum Tier 1 leverage ratio of 4.0%. CET1 generally consists of common stock and retained earnings, subject to applicable adjustments and deductions. Under new prompt corrective action regulations, in order to be considered "well capitalized", the Bank must maintain a CET1 capital ratio of 6.5% (new) and a Tier 1 ratio of 8.0% (increased from 6.0%), a total risk based capital ratio of 10.0% (unchanged) and a Tier 1 leverage ratio of 5.0% (unchanged). In addition, the regulations establish a capital conservation buffer above the required capital ratios that began phasing in January 1, 2016 at 0.625% of risk-weighted assets and increases each year by 0.625% until it is fully phased in at 2.5% effective January 1, 2019. Beginning January 1, 2016, failure to maintain the capital conservation buffer will limit the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses.

The new regulations implemented changes to what constitutes regulatory capital. Certain instruments will no longer constitute qualifying capital, subject to phase-out periods. In addition, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of CET1 will be deducted from capital. The Bank has elected to permanently opt-out of the inclusion of accumulated other comprehensive income (loss) in capital calculations, as permitted by the regulations. This opt-out will reduce the impact of market volatility on the Bank's regulatory capital ratios.

The new regulations also changed the risk weights of certain assets, including an increase in the risk weight of certain high volatility commercial real estate acquisition, development and construction loans and non-residential mortgage loans that are 90 days past due or on non-accrual status to 150% from 100%, a credit conversion factor for the unused portion of commitments with maturities of less than one year that are not cancellable to 20% from 0%, an increase in the risk weight for mortgage servicing rights and deferred tax assets that are not deducted from capital to 250% from 100%, and an increase in the risk weight for equity exposures to 600% from 100%.

Management believes, as of December 31, 2016, that the Company and the Bank meet 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, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1 and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

On January 1, 2016 the Company and the Bank became subject to the "capital conservation buffer" requirement, which is being phased in over the next three years, increasing each year until fully implemented at 2.5% on January 1, 2019. The requirement would limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a "capital conservation buffer" consisting of 2.5% in addition to the minimum capital requirements. At December 31, 2016, the Company and the Bank exceeded the fully phased in regulatory requirement for the "capital conservation buffer."

NOTE 11 REGULATORY MATTERS (CONTINUED)

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

	Actual			For Capital Adequacy Purposes			To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio		Amount	Ratio		Amount	Ratio
	(Dollars amounts in thousands)							
<u>As of December 31, 2016:</u>								
Total Capital (to Risk Weighted Assets):								
Consolidated	\$ 95,186	16.23 %	\$	46,922	8.00 %		N/A	N/A
Northway Bank	92,786	15.95		46,544	8.00	\$	58,180	10.00 %
Tier 1 Capital (to Risk Weighted Assets):								
Consolidated	87,565	14.93		35,192	6.00		N/A	N/A
Northway Bank	85,224	14.65		34,908	6.00		46,544	8.00
Common Equity Tier 1 Capital (to Risk Weighted Assets):								
Consolidated	68,082	11.61		N/A	N/A		N/A	N/A
Northway Bank	85,224	14.65		26,181	4.50		37,817	6.50
Tier 1 Capital (to Average Assets):								
Consolidated	87,565	9.83		35,649	4.00		N/A	N/A
Northway Bank	85,224	9.61		35,469	4.00		44,336	5.00
<u>As of December 31, 2015:</u>								
Total Capital (to Risk Weighted Assets):								
Consolidated	\$ 92,999	16.39 %	\$	45,389	8.00 %		N/A	N/A
Northway Bank	90,229	16.04		44,996	8.00	\$	56,245	10.00 %
Tier 1 Capital (to Risk Weighted Assets):								
Consolidated	85,883	15.14		34,041	6.00		N/A	N/A
Northway Bank	83,174	14.79		33,747	6.00		44,996	8.00
Common Equity Tier 1 Capital (to Risk Weighted Assets):								
Consolidated	66,004	11.63		N/A	N/A		N/A	N/A
Northway Bank	83,174	14.79		25,310	4.50		36,559	6.50
Tier 1 Capital (to Average Assets):								
Consolidated	85,883	9.08		37,847	4.00		N/A	N/A
Northway Bank	83,174	8.84		37,626	4.00		47,032	5.00

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

As of December 31, 2016, the Bank is restricted from declaring dividends to Northway in an amount greater than approximately \$47,177, as such declaration would decrease capital below the Bank's required minimum level of regulatory capital.

Under New Hampshire state law, the Bank may pay dividends only out of net profits. The State of New Hampshire Banking Commissioner's approval is required for dividend payments which exceed the current year's net profits and retained net profits from the preceding two years. As of December 31, 2016, the Bank is restricted from declaring dividends to the Company in an amount greater than \$9,664.

NOTE 12 OTHER NONINTEREST EXPENSE

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

	<u>2016</u>	<u>2015</u>
Professional fees	\$ 2,082	\$ 1,874
Software expenses	915	874
ATM & debit card expenses	778	676
Telecommunications	401	415
FDIC insurance	388	574
Other	<u>3,466</u>	<u>3,095</u>
	<u>\$ 8,030</u>	<u>\$ 7,508</u>

NOTE 13 FEDERAL AND STATE TAXES

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

	<u>2016</u>	<u>2015</u>
Current		
Federal	\$ 1,216	\$ 1,797
State	<u>(42)</u>	<u>25</u>
	<u>1,174</u>	<u>1,822</u>
Deferred		
Federal	(351)	343
State	<u>123</u>	<u>315</u>
	<u>(228)</u>	<u>658</u>
Total	<u>\$ 946</u>	<u>\$ 2,480</u>

NOTE 13 FEDERAL AND STATE TAXES (CONTINUED)

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

	<u>2016</u>	<u>2015</u>
Deferred income tax assets		
Allowance for loan losses	\$ 3,170	\$ 3,520
Interest on nonaccrual loans	339	484
Net unrealized holding loss on securities available-for-sale	1,042	433
Net unrealized holding loss on limited partnership	5	6
Pension unfunded status valuation adjustment	-	1,563
OREO write-down	-	27
Supplemental pension	1,065	1,074
Contribution carry-forward	10	-
New Hampshire Business Enterprise Tax credit carryforward	19	201
Accruals and reserves	26	-
Alternative Minimum Tax (AMT) tax credit carryforward	1,255	1,470
Other	19	-
	<u>6,950</u>	<u>8,778</u>
Deferred income tax liabilities		
Depreciation	(776)	(775)
Amortization of goodwill and core deposit intangible	(3,366)	(3,192)
Prepaid pension	-	(1,276)
Net unrealized gain on on interest rate swaps	(253)	-
	<u>(4,395)</u>	<u>(5,243)</u>
Deferred income tax asset, net	<u>\$ 2,555</u>	<u>\$ 3,535</u>

The primary sources of recovery of the deferred income tax asset are taxes paid that are available for carryback and the expectation that the deductible temporary differences will reverse during periods in which the Company generates taxable income. The Company reduces deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is not "more likely than not" that some portion or all of the deferred tax assets will be realized. The Company assesses the realizability of its deferred tax assets by assessing the likelihood of the Company generating federal and state tax income, as applicable, in future periods in amounts sufficient to offset the deferred tax charges in the periods they are expected to reverse. Based on this assessment, management concluded that a valuation allowance was not required as of December 31, 2016 and 2015. The New Hampshire Business Enterprise Tax credit carryforward will expire between 2017 and 2018. The Federal AMT tax credit carryforward does not expire.

Total income tax expense for the years ended December 31, 2016 and 2015 differs from the "expected" federal income tax expense at the 34% statutory rate for the following reasons:

	<u>2016</u>	<u>2015</u>
Expected federal income taxes	34.0 %	34.0 %
Interest on municipal securities available-for-sale and municipal loans	(13.6)	(9.3)
State expense, net of federal expense	1.1	2.5
Other	(2.4)	0.5
Effective tax rate	<u>19.1 %</u>	<u>27.7 %</u>

It is the Company's policy to provide for uncertain tax positions and the related interest and penalties based upon management's assessment of whether a tax benefit is more likely than not to be sustained upon examination by tax authorities. As of December 31, 2016 and 2015, there were no material uncertain tax positions related to federal and state tax matters. The Company's income tax returns are subject to review and examination by federal and state taxing authorities. The Company is currently open to audit under the applicable statutes of limitations by federal and state taxing authorities for the years ended December 31, 2013 through 2016.

NOTE 14 EMPLOYEE BENEFITS

Pension Plan

The Company previously maintained a trustee non-contributory pension plan (the “Plan”) covering substantially all full-time employees. Assuming retirement at age 65 after 30 years or more of service, the benefits are computed as the sum of 1% of final average earnings up to a covered compensation limit, plus 0.65% of final average earnings in excess of covered compensation, times years of service, up to 30. Final average earnings are defined as the five consecutive years out of the employee’s last ten years of employment during which compensation is highest. The amounts contributed to the Plan are determined annually on the basis of (a) the maximum amount that can be deducted for federal income tax purposes or (b) the amount certified by a consulting actuary as necessary to avoid an accumulated funding deficiency as defined by the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only benefits attributed to service to date, but also for those expected to be earned in the future.

In October 2015, the Company approved the freezing of benefit accruals and future participation in the Plan effective December 31, 2015. The Plan was terminated effective January 31, 2016 with an annuity purchase and lump sum distributions completed in October and November 2016, respectively, settling all benefit obligations in the Plan. Concurrent with this termination, the Company changed its contribution to its 401(k) plan as explained below.

The following table sets forth information about the Plan as of December 31, 2016 and 2015 and for the years then ended:

	<u>2016</u>	<u>2015</u>
Obligations and funded status		
<u>Change in benefit obligation</u>		
Projected benefit obligation at beginning of year	\$ 16,393	\$ 17,547
Service cost	-	1,025
Interest cost	571	718
Actuarial loss	1,834	2
Benefits paid	(395)	(464)
Curtailment gain	-	(2,435)
Settlement payments	(16,216)	-
Settlement gain	(2,187)	-
Projected benefit obligation at end of year	<u>-</u>	<u>16,393</u>
<u>Change in plan assets</u>		
Fair value of plan assets at beginning of year	15,669	14,984
Actual return on plan assets	938	149
Employer contributions	4	1,000
Benefits paid	(395)	(464)
Settlement payments	(16,216)	-
Fair value of plan assets at end of year	<u>-</u>	<u>15,669</u>
Funded status at end of year	<u>\$ -</u>	<u>\$ (724)</u>
<u>Amounts recognized in accumulated other comprehensive loss consist of:</u>		
Unrecognized prior service credit	\$ -	\$ -
Unrecognized net loss	-	3,945
Total	<u>\$ -</u>	<u>\$ 3,945</u>
Accumulated benefit obligation	\$ -	\$ 16,393

NOTE 14 EMPLOYEE BENEFITS (CONTINUED)

	<u>2016</u>	<u>2015</u>
<u>Net periodic pension cost</u>		
Service cost	\$ -	\$ 1,025
Interest cost	571	718
Expected return on plan assets	(559)	(989)
Amortization of prior service credit	-	(34)
Amortization of net actuarial loss	136	264
Recognized curtailment loss	-	2
Recognized settlement loss	3,077	-
Net periodic pension cost	<u>3,225</u>	<u>986</u>

Other changes in plan assets and benefit obligations recognized in other comprehensive (income)/loss

Net actuarial gain for period	(732)	(1,593)
Amortization of prior service credit	-	34
Amortization of net actuarial loss	(136)	(264)
Recognized curtailment loss	-	(2)
Recognized settlement loss	(3,077)	-
Total	<u>(3,945)</u>	<u>(1,825)</u>

Total recognized net periodic pension cost and other comprehensive income	<u>\$ (720)</u>	<u>\$ (839)</u>
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Assumptions

	<u>2016</u>	<u>2015</u>
<u>Weighted-average assumptions used to determine pension obligations at measurement date</u>		
Discount rate	N/A	4.25 %
Rate of compensation increase	N/A	2.75

Weighted-average assumptions used to determine net periodic pension cost for the years ended December 31.

Discount rate	4.25 %	4.25 %
Expected long-term rate of return on plan assets	4.25	6.50

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

	<u>Percentage of Plan Assets at December 31:</u>	
	<u>2016</u>	<u>2015</u>
<u>Asset category</u>		
Mutual funds:		
Bond funds	-	66.0 %
Short-term money market	-	34.0
Total	<u>- %</u>	<u>100.0 %</u>

NOTE 14 EMPLOYEE BENEFITS (CONTINUED)

The Company's pension plan assets are generally classified within level 2 of the fair value hierarchy (See Note 18, "Fair Value Measurements", for a description of the fair value hierarchy), because they are valued using third-party pricing services for identical or comparable assets.

The fair values of the Company's pension plan assets at December 31, 2015, by asset category, are as follows:

<u>Fair Value Measurements at Reporting Date Using:</u>				
<u>Category</u>	<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 Other Observable Inputs Level 3</u>
<u>December 31, 2015</u>				
<u>Common/collective trust funds</u>				
Corporate bond funds	\$ 10,370	\$ -	\$ 10,370	\$ -
Money market	5,299	-	5,299	-
Totals	<u>\$ 15,669</u>	<u>\$ -</u>	<u>\$ 15,669</u>	<u>\$ -</u>

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

<u>Asset category</u>	<u>2016</u>	<u>2015</u>
Mutual funds:		
Bond funds	N/A	100%

The plan assets do not include any Northway common stock at December 31, 2015.

401(k) Plan

The Company offers a contributory 401(k) Plan. Under the Northway Financial, Inc. 401(k) and Profit Sharing Plan (the "401(k) Plan"), employees are eligible to participate after attaining age 21, completing six months of service and having been credited with at least 1,000 hours of service. Under the 401(k) Plan during 2016, the Company matched 100% of the first 3% of employee contributions and 50% of the next 2% of employee contributions. Under the 401(k) Plan during 2015, the Company matched 50% of the first 4% of employee contributions. Total 401(k) Plan matching expense in 2016 and 2015 amounted to \$385 and \$166, respectively, and there was no profit sharing contribution expense for each of the years ended December 31, 2016 and 2015.

Supplemental Executive Retirement Plan (SERP)

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

The SERP consists of two components. The first component is a distribution of the account balance in equal installments over the ten years following the CEO's retirement without interest. This account balance reflects the cumulative net appreciation in a life insurance policy with a gross-up to reflect the Company's tax savings. The net appreciation is the gain in the surrender value of the life insurance policy less the cost of the premiums and benefit payments. The cost of premiums and benefits for 2016 was 1.80%. The account balance at the November 19, 2016 plan year end was \$1,064. If the CEO dies before the end of the ten-year period, his beneficiary receives the unpaid portion in a lump sum. The second component is a lifetime distribution beginning in the second year following retirement equal to the annual net appreciation in the life insurance policy with a gross-up to reflect the Company's tax savings. As of December 31, 2016 and 2015, the Company has accrued a liability related to the SERP in the amount

NOTE 14 EMPLOYEE BENEFITS (CONTINUED)

of \$2,642 and \$2,643, respectively. The respective liabilities reflect the present value of all expected postretirement benefits. In the event of the CEO's death while employed by the Company, the SERP permits a death benefit of \$2,000 be paid to his beneficiary.

Change in Control

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

NOTE 15 COMMITMENTS AND CONTINGENT LIABILITIES

The Company is obligated under non-cancelable leases expiring between September 2017 and March 2023. Options to renew for additional terms are included under certain lease agreements and are not included in the table below. The Company has one cancelable lease expiring in May 2018. The total minimum rental due in future periods under these existing agreements is as follows as of December 31, 2016:

2017	\$ 477
2018	436
2019	304
2020	274
2021	164
Thereafter	150
	<u>\$ 1,805</u>

Rent expense for the years ended December 31, 2016 and 2015 amounted to \$559 and \$500, respectively.

The Company is obligated under a Service Agreement with Enhanced Communications of Northern New England Inc. to pay a termination charge equal to 100% of the monthly recurring charge times the number of months remaining in the service agreement. The agreement was effective December 23, 2015 for sixty months. At December 31, 2016, the remaining term was forty-seven months for a total commitment of \$282.

NOTE 16 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

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

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

NOTE 16 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

	2016	2015
Financial instruments whose contract amounts represent credit risk:		
Unadvanced portions of home equity loans	\$ 23,604	\$ 23,851
Unadvanced portions of lines of credit	41,803	38,244
Unadvanced portions of commercial real estate loans	9,963	10,331
Unadvanced portions of Bounce Protection TM	14,024	14,580
Commitments to originate municipal loans	-	20,000
Commitments to originate all other loans	13,958	4,540
Standby letters of credit	1,637	1,273
Total	<u>\$ 104,989</u>	<u>\$ 112,819</u>

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

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

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers. As of December 31, 2016 and 2015, the maximum potential amount of the Company's obligation was \$1,637 and \$1,273, respectively, for financial and standby letters of credit. The Company's outstanding letters of credit generally have a term of less than one year. If a letter of credit is drawn upon, the Company may seek recourse through the customer's underlying line of credit. If the customer's line of credit is also in default, the Company may take possession of the collateral, if any, securing the line of credit.

The Company accrues for credit losses related to off-balance sheet financial instruments. Potential losses on off-balance sheet loan commitments are estimated using the same methodologies employed in calculating the general component of the allowance for loan losses.

NOTE 17 ON-BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES*Risk Management Policies – Hedging Instruments*

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

Interest Rate Risk Management – Cash Flow Hedging Instruments

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

NOTE 17 ON-BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (CONTINUED)

At December 31, 2016 and 2015, the information pertaining to outstanding interest rate swap agreements used to hedge variable rate debt is as follows:

	2016	2015
Notional amount	\$ 20,000	N/A
Weighted average pay rate	2.745 %	N/A
Weighted average receive rate	3-month LIBOR plus 1.20 %	N/A
Weighted average maturity in years	4.71	N/A
Unrealized gain relating to interest rate swaps	\$ 638	N/A

These agreements provide for the Company to receive payments at a variable rate determined by a specified index (three-month LIBOR) in exchange for making payments at a fixed rate.

During 2016, no interest rate swap agreements were terminated prior to maturity. At December 31, 2016, the unrealized gain relating to interest swaps was recorded in derivative liabilities in accordance with ASC 815. Changes in the fair value of interest rate swaps designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings. None of the other comprehensive income was reclassified into interest expense during the year ended December 31, 2016.

Risk management results for the year ended December 31, 2016 related to the balance sheet hedging of long-term debt indicates that the hedges were 100% effective and that there was no component of the derivative instruments' gain or loss which was excluded from the assessment of hedge effectiveness.

None of the losses reported in other comprehensive income related to the interest rate swaps were expected to be reclassified into interest expense as a yield adjustment of the hedged borrowings during the twelve-month period ending December 31, 2016.

Interest Rate Risk Management – Derivative Instruments Not Designated As Hedging Instruments

The Company enters into rate lock commitments to extend credit to borrowers for generally a 30-day or 60-day period for the origination and/or purchase of loans. Unfunded loans for which commitments have been entered into are called "pipeline loans". Some of these rate lock commitments will ultimately expire without being completed. To the extent that a loan is ultimately granted and the borrower ultimately accepts the terms of the loan, these rate lock commitments expose the Company to variability in their fair value due to changes in interest rates. If interest rates increase, the value of these rate lock commitments decreases. Conversely, if interest rates decrease, the value of these rate lock commitments increases.

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

There were no derivatives held related to mortgage banking activities during 2016, nor outstanding as of December 31, 2016.

Collateral Requirements

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

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

By using derivatives, the Company is exposed to credit risk to the extent that counterparties to the derivative contracts do not perform as required. Should a counterparty fail to perform under the terms of a derivative contract, the Company's counterparty credit risk is equal to the amount reported as a derivative asset in the consolidated balance sheet. The Company seeks to minimize

NOTE 17 ON-BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES (CONTINUED)

counterparty credit risk through credit approvals, limits, monitoring procedures, execution of master netting arrangements and obtaining collateral, where appropriate. Counterparties to the Company's derivatives include major financial institutions with investment grade credit ratings from the major rating agencies. As such, management believes the risk of incurring credit losses on derivative contracts with those counterparties is remote and losses, if any, would be immaterial.

Derivative Financial Instruments - Interest Rate Swaps

The Company may, from time to time, enter into pay fixed/receive floating interest rate swaps that are used to manage interest rate risk associated with certain interest-earning assets and interest-bearing liabilities, principally commercial real estate loans.

At December 31, 2016, the Company had four such agreements outstanding with commercial business customers. The Company pays interest to the customers at a floating rate on the notional amount and receives interest from the customers at a fixed rate on the same notional amount. Concurrently, the Company entered into offsetting interest rate swaps with a financial institution counterparty. In the offsetting swaps, the Company pays the counterparty interest at the same fixed rate on the same notional amount as the swap entered into with the customers, and receives interest from the counterparty for the same floating rate on the same notional amount.

As a result, the interest rate swaps effectively converted the fixed rate asset to a variable interest rate and consequently reduced the Company's exposure to changes in interest rates. These swaps are accounted for as fair value hedges with changes in their fair value offsetting each other.

At December 31, summary information regarding these derivatives is presented below:

	Notional Amount	Maturity Date	Interest Rate Paid Monthly	Interest Rate Received Monthly	Fair Value
December 31, 2016					
Customer interest rate swap	\$ 2,925	June 15, 2029	1-mo LIBOR + 2.0%	Fixed: 4.63%	\$ 107
Counterparty interest rate swap	2,925	June 15, 2029	Fixed: 4.63%	1-mo LIBOR + 2.0%	(107)
Customer interest rate swap	\$ 9,800	November 29, 2032	1-mo LIBOR + 1.88%	Fixed: 3.73%	\$ (630)
Counterparty interest rate swap	9,800	November 29, 2032	Fixed: 3.73%	1-mo LIBOR + 1.88%	630
Customer interest rate swap	\$ 6,500	December 1, 2026	1-mo LIBOR + 1.85%	Fixed: 3.95%	\$ -
Counterparty interest rate swap	6,500	December 1, 2026	Fixed: 3.95%	1-mo LIBOR + 1.85%	-
Customer interest rate swap	\$ 5,246	August 19, 2023	1-mo LIBOR + 1.75%	Fixed: 3.15%	\$ (161)
Counterparty interest rate swap	5,246	August 19, 2023	Fixed: 3.15%	1-mo LIBOR + 1.75%	161
December 31, 2015					
Customer interest rate swap	\$ 3,159	June 15, 2029	1-mo LIBOR + 2.0%	Fixed: 4.63%	\$ 161
Counterparty interest rate swap	3,159	June 15, 2029	Fixed: 4.63%	1-mo LIBOR + 2.0%	(161)

(1) Derivative assets and liabilities are recorded within other assets and other liabilities in the consolidated financial statements.

As of December 31, 2016, the Company held restricted cash in the amount of \$1,650 as collateral for the interest rate swaps. There was no restricted cash held as of December 31, 2015.

NOTE 18 FAIR VALUE MEASUREMENTS

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

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

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

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

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

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

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

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

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

Derivative-interest rate swap: The carrying amount reported in the consolidated balance sheets for Derivative - interest rate swap represents the fair value of the instruments. The fair value is estimated using discounted cash flow analysis using interest rates currently being offered for similar instruments.

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

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

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

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

Off-balance sheet instruments: The fair value of commitments to originate loans is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments and the unadvanced portion of loans, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligation with the counterparties at the reporting date. See Note 15, "Commitments and Contingent Liabilities," for further information.

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

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

	December 31, 2016				
	Carrying Amount	Fair Value			Total
		Level 1	Level 2	Level 3	
Financial assets:					
Cash and cash equivalents	\$ 44,854	\$ 44,854	\$ -	\$ -	\$ 44,854
Securities available-for-sale	261,008	19,377	241,631	-	261,008
FHLBB stock	1,398	1,398	-	-	1,398
Loans held-for-sale	242	-	247	-	247
Loans, net	545,594	-	-	549,541	549,541
Accrued interest receivable	2,579	2,579	-	-	2,579
Derivative - interest rate swap	684	-	684	-	684

Financial liabilities:					
Deposits	737,732	580,780	159,359	-	740,139
Short-term borrowings	50,528	50,528	-	-	50,528
Junior subordinated debentures	20,620	-	17,994	-	17,994
Derivative - interest rate swap	684	-	684	-	684

	December 31, 2015				
	Carrying Amount	Fair Value			Total
		Level 1	Level 2	Level 3	
Financial assets:					
Cash and cash equivalents	\$ 91,479	\$ 91,479	\$ -	\$ -	\$ 91,479
Interest-bearing time deposits with other banks	248	-	249	-	249
Securities available-for-sale	254,476	13,405	241,071	-	254,476
FHLBB stock	3,158	3,158	-	-	3,158
Loans held-for-sale	249	-	255	-	255
Loans, net	547,299	-	-	549,290	549,290
Accrued interest receivable	2,696	2,696	-	-	2,696
Derivative - interest rate swap	161	-	161	-	161

Financial liabilities:					
Deposits	757,922	548,145	213,821	-	761,966
Short-term borrowings	44,042	44,042	-	-	44,042
FHLBB advances	34,907	-	36,180	-	36,180
Junior subordinated debentures	20,620	-	17,702	-	17,702
Derivative - interest rate swap	161	-	161	-	161

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

At December 31, 2016 and 2015, all the Company's financial instruments were held for purposes other than trading.

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

Limitations

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

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

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

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

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

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

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

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value for December 31, 2016 and 2015. The Company did not have any significant transfers of assets between level 1 and level 2 of the fair value hierarchy during the year ended December 31, 2016.

The Company's marketable equity securities are generally classified within level 1 of the fair value hierarchy because they are valued using quoted market prices.

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

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used. Subsequent to inception, management only changes level 3 inputs and assumptions when corroborated by evidence such as transactions in similar instruments, completed or pending third-party transactions in the underlying investment or comparable entities, subsequent rounds of financing, recapitalization and other transactions across the capital structure, offerings in the equity or debt markets, and changes in financial ratios or cash flows.

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

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

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

The following summarizes assets measured at fair value on a recurring basis for the periods ending December 31, 2016 and 2015:

Fair Value Measurements at Reporting Date Using:				
	Total	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<u>December 31, 2016</u>				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 27,095	\$ -	\$ 27,095	\$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	107,964	-	107,964	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	52,192	-	52,192	-
State and political subdivision bonds	54,380	-	54,380	-
Marketable equity securities	19,377	19,377	-	-
Derivative - interest rate swap	684	-	684	-
Total	<u>\$ 261,692</u>	<u>\$ 19,377</u>	<u>\$ 242,315</u>	<u>\$ -</u>
	Total	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>				
U.S. Treasury and other U.S. government agency and sponsored enterprise securities	\$ 38,574	\$ -	\$ 38,574	\$ -
U.S. government agency and sponsored enterprise mortgage-backed securities	120,133	-	120,133	-
Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises	40,875	-	40,875	-
State and political subdivision bonds	41,489	-	41,489	-
Marketable equity securities	13,405	13,405	-	-
Derivative - interest rate swap	161	-	161	-
Total	<u>\$ 254,637</u>	<u>\$ 13,405</u>	<u>\$ 241,232</u>	<u>\$ -</u>

NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

The following summarizes liabilities measured at fair value on a recurring basis for the years ending December 31, 2016 and 2015:

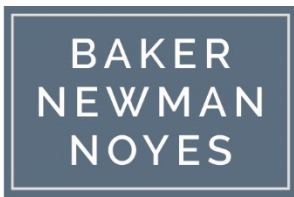
	Total	Fair Value Measurements at Reporting Date Using:		
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<u>December 31, 2016</u>				
Derivative - interest rate swap	684	-	684	-
Total	<u>\$ 684</u>	<u>\$ -</u>	<u>\$ 684</u>	<u>\$ -</u>
<u>December 31, 2015</u>				
Derivative - interest rate swap	161	-	161	-
Total	<u>\$ 161</u>	<u>\$ -</u>	<u>\$ 161</u>	<u>\$ -</u>

Under certain circumstances the Company makes adjustments to its assets and liabilities although they are not measured at fair value on an ongoing basis. The following table presents the carrying value of assets reflected in the consolidated balance sheets by caption and by level in the fair value hierarchy at December 31, 2016 and 2015, for which a nonrecurring change in fair value has been recorded.

	Total	Fair Value Measurements at Reporting Date Using:		
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
<u>December 31, 2016</u>				
Impaired loans	\$ 3,118	\$ -	\$ -	\$ 3,118
OREO	32	-	-	32
Totals	<u>\$ 3,150</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,150</u>
<u>December 31, 2015</u>				
Impaired loans	\$ 1,786	\$ -	\$ -	\$ 1,786
OREO	376	-	-	376
Totals	<u>\$ 2,162</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,162</u>

NOTE 19 SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 24, 2017, which is the date the consolidated financial statements were available to be issued. The Company paid a cash dividend of \$881, or \$0.32 per share, to common shareholders on February 13, 2017. There were no other subsequent events that require adjustment to or disclosure in the consolidated financial statements.



INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders
Northway Financial, Inc.
North Conway, New Hampshire

We have audited the accompanying consolidated financial statements of Northway Financial, Inc. and Subsidiary 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 accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free 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 auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Northway Financial, Inc. and Subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Baker Newman & Noyes LLC

Peabody, Massachusetts
March 24, 2017

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