FJ-0

FR Y-6
OMB Number 7100-0297
Approval expires November 30, 2019
Page 1 of 2

**Board of Governors of the Federal Reserve System**

# Annual Report of Holding Companies—FR Y-6

**Report at the close of business as of the end of fiscal year**

This Report is required by law: Section 5(c)(1)(A) of the Bank Holding Company Act (12 U.S.C. § 1844(c)(1)(A)); sections 8(a) and 13(a) of the International Banking Act (12 U.S.C. §§ 3106(a) and 3108(a)); sections 11(a)(1), 25, and 25A of the Federal Reserve Act (12 U.S.C. §§ 248(a)(1), 602, and 611a); and sections 113, 165, 312, 618, and 809 of the Dodd-Frank Act (12 U.S.C. §§ 5361, 5365, 5412, 1850a(c)(1), and 5468(b)(1)). Return to the appropriate Federal Reserve Bank the original and the number of copies specified.

This report form is to be filed by all top-tier bank holding companies, top-tier savings and loan holding companies, and U.S. intermediate holding companies organized under U.S. law, and by any foreign banking organization that does not meet the requirements of and is not treated as a qualifying foreign banking organization under Section 211.23 of Regulation K (12 C.F.R. § 211.23). (See page one of the general instructions for more detail of who must file.) The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, an information collection unless it displays a currently valid OMB control number.

NOTE: The *Annual Report of Holding Companies* must be signed by one director of the top-tier holding company. This individual should also be a senior official of the top-tier holding company. In the event that the top-tier holding company does not have an individual who is a senior official and is also a director, the chairman of the board must sign the report. If the holding company is an ESOP/ESOT formed as a corporation or is an LLC, see the General Instructions for the authorized individual who must sign the report.

I, Jon J. Prescott
Name of the Holding Company Director and Official

President & CEO
Title of the Holding Company Director and Official

attest that the *Annual Report of Holding Companies* (including the supporting attachments) for this report date has been prepared in conformance with the instructions issued by the Federal Reserve System and are true and correct to the best of my knowledge and belief.

*With respect to information regarding individuals contained in this report, the Reporter certifies that it has the authority to provide this information to the Federal Reserve. The Reporter also certifies that it has the authority, on behalf of each individual, to consent or object to public release of information regarding that individual. The Federal Reserve may assume, in the absence of a request for confidential treatment submitted in accordance with the Board's "Rules Regarding Availability of Information," 12 C.F.R. Part 261, that the Reporter and individual consent to public release of all details in the report concerning that individual.*

Signature of Holding Company Director and Official

03/28/2018
Date of Signature

*For holding companies not registered with the SEC–*
Indicate status of Annual Report to Shareholders:

- [x] is included with the FR Y-6 report
- [ ] will be sent under separate cover
- [ ] is not prepared

**For Federal Reserve Bank Use Only**

RSSD ID 1140127
C.I. ______

**Date of Report** (top-tier holding company's fiscal year-end):
December 31, 2017
Month / Day / Year

549300PRPWWDL1R15M21 Katahdin Trust Company
Reporter's Legal Entity Identifier (LEI) (20-Character LEI Code)

Reporter's Name, Street, and Mailing Address

Katahdin Bankshares Corp. ✓
Legal Title of Holding Company

11 Main Street
(Mailing Address of the Holding Company) Street / P.O. Box

| Patten | ME | 04765 |
|---|---|---|
| City | State | Zip Code |

Physical Location (if different from mailing address)

Person to whom questions about this report should be directed:

| Joseph Porter | VP, Controller |
|---|---|
| Name | Title |

207-521-3228
Area Code / Phone Number / Extension

207-521-0456
Area Code / FAX Number

j.porter@katahdintrust.com
E-mail Address

www.katahdintrust.com
Address (URL) for the Holding Company's web page

Is confidential treatment requested for any portion of this report submission? ........ 0=No 1=Yes **0**

In accordance with the General Instructions for this report (check only one),

1. a letter justifying this request is being provided along with the report ........ ☐
2. a letter justifying this request has been provided separately ... ☐

NOTE: Information for which confidential treatment is being requested must be provided separately and labeled as "confidential."

# For Use By Tiered Holding Companies

*Top-tiered holding companies must list the names, mailing address, and physical locations of each of their subsidiary holding companies below.*

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

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City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

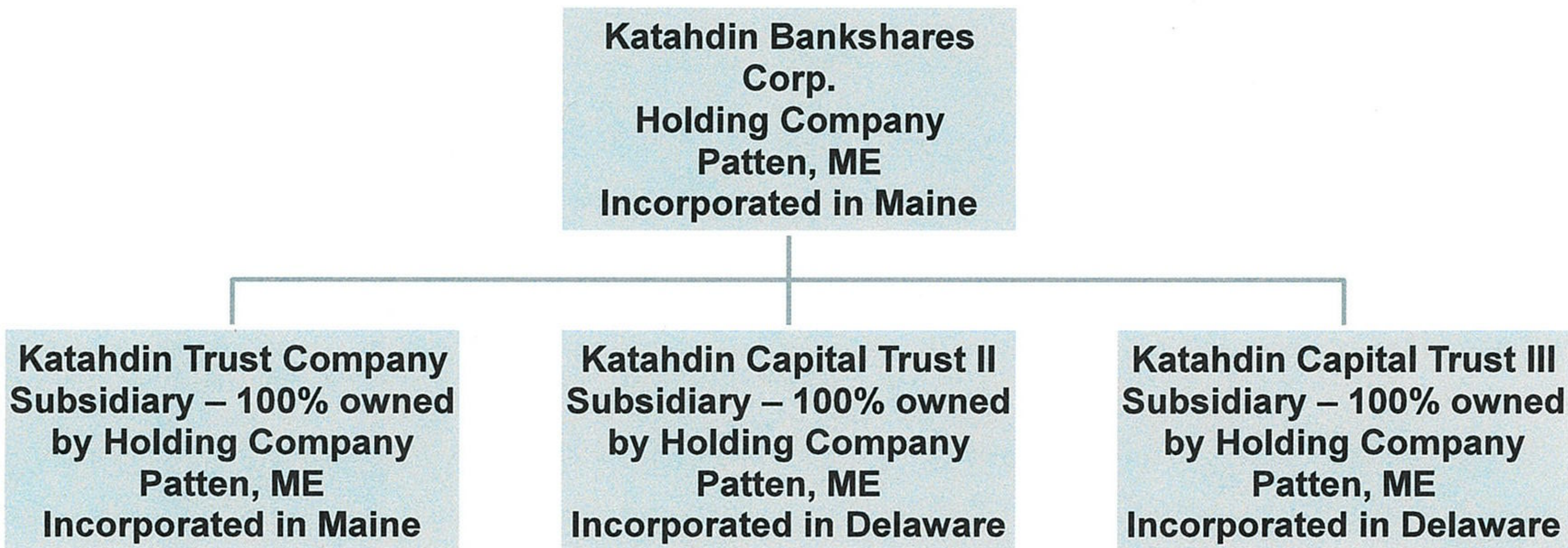
City State Zip Code

Physical Location (if different from mailing address)

**Report Item 2: Organization Chart**

(1.)

The LEI is 549300PRPWWDL1RI5M21 (Katahdin trust company)




(2.) None

(3.) None

**FR Y-6**
**For year-end December 31, 2017**
**Katahdin Bankshares Corp.**
**Main Street, P O Box 450**
**Patten, Maine 04765**

**Report Item 1a: Form 10-K filed with the Securities and Exchange Commission**
None

**Report Item 1b: Annual reports to shareholders**
Enclosed

**Report Item 3: Shareholders**

**(1) CEDE & Co.**
New York, NY/USA
Country of Incorporation – United States of America
2,194,396 shares of Common Stock = 64.27%

**Report Item 4: Principal Shareholders, Directors & Officers**

**Principal Shareholders:**

| | |
|---|---|
| 1. Name & Address: | **CEDE & Co.**, New York, NY/USA |
| 2. Principal Occupation: | Depository Trust Company |
| 3. Title/Position: | N/A |
| 4. % of each class: | 64.27% of stock in Katahdin Bankshares Corp., (beneficial interest) |

**Directors:**

| | |
|---|---|
| 1. Name & Address: | **Robert E. Anderson**, Houlton, ME/USA |
| 2. Principal Occupation: | Insurance Sales |
| 3. Title/Position: | a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Director & Chairman of the Board of F. A. Peabody Company |
| 4. % of each class: | a. Owner of 1.02% of stock in Katahdin Bankshares Corp., c. Owner of 37.34% of stock in F. A. Peabody Co. |

| | |
|---|---|
| 1. Name & Address: | **Steven L. Richardson,** Patten, ME/USA |
| 2. Principal Occupation: | Businessman – Retail Store Owner |
| 3. Title/Position: | a. Chairman of the Board & Director of Katahdin Bankshares Corp., b. Chairman of the Board & Director of Katahdin Trust Company, c. Partner in Richardson's Hardware. |
| 4. % of each class: | a. Owner of 2.76% of stock in Katahdin Bankshares Corp., b. Owner of 75% of stock in Richardson's Hardware. |

| | |
|---|---|
| 1. Name & Address: | **Richard B. Harnum, Jr.** Bangor, ME/USA |
| 2. Principal Occupation: | Commercial Real Estate Development and Wholesale HVAC and Plumbing Distributor |
| 3. Title/Position: | a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. owner and President of Webber Group of Companies, d. owner and manager of Harnum Family, LLC, e. owner and manager of M&H Family, LLC, f. owner and manager of RBH Enterprises, LLC, g. owner and manager of Lucerne Properties, LLC |
| 4. % of each class: | a. Does not own any stock in Katahdin Bankshares Corp.; c. owner of 21% of stock in Webber Group of Companies; d. owner of 50% of stock in Harnum Family, LLC, e. owner of 37.5% of stock in M&H Family, LLC, f. owner of 100% of stock in RBH Enterprises, LLC, g. owner of 100% of stock in Lucerne Properties, LLC. |

| | |
|---|---|
| 1. Name & Address: | **Paul R. Powers,** Caribou, ME/USA |
| 2. Principal Occupation: | Contractor |
| 3. Title/Position: | a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Owner of Powers Roofing & Sheet Metal, Inc. d. Owner of B.J.J. Powers Enterprises, LLC, e. Partner in Aroostook County Redevelopment Association, f. Partner in Northern Maine Brewing Company. |
| 4. % of each class: | a. Owner of 1.26% of stock in Katahdin Bankshares Corp. c. Owner of 70% stock in Powers Roofing & Sheet Metal, Inc., d. Owner of 100% of stock in B.J.J. Powers Enterprises; e. Owner of 6.0 % stock in Aroostook County Redevelopment Association; f. Owner of 16% stock in Northern Maine Brewing Company. |

| | |
|---|---|
| 1. Name & Address: | **Peter F. Briggs,** Kennebunk, ME/USA |
| 2. Principal Occupation: | Retired, Beer & Wine Wholesaler |
| 3. Title/Position: | a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company |
| 4. % of each class: | a. Owner of 1.41% of stock in Katahdin Bankshares Corp. |

| | |
|---|---|
| 1. Name & Address: | **Richard J. York,** Houlton, ME/USA |
| 2. Principal Occupation: | Automobile Dealer |
| 3. Title/Position: | a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Owner of York Ford Sales, d. Owner of York Leasing, Inc., e. Owner of Freshstart Finance Company, f. Owner of York Reinsurance Ltd. g. Owner of Nature's Circle Farm |
| 4. % of each class | a. Owner of 1.08% of stock in Katahdin Bankshares Corp., c. Owner of 47.50% of stock in York's of Houlton, d. Owner of 47.50% of stock in York Leasing Inc., e. Owner of 47.50% of stock in Freshstart Finance Company, f. Owner of 47.50% of stock in York Reinsurance Ltd., g. Owner of 65% of stock in Nature's Circle Farm. |

1. Name & Address: **Kimberley A. Niles,** Plaistow, NH/USA
2. Principal Occupation: Acquisition Business Owner Managing Director and CFO of Constant Energy Capital Management
3. Title/Position: a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Managing Director of State of Granite, LLC (d) Board of Directors of Side X Side, Inc.
4. % of each class: a. Does not own any stock in Katahdin Bankshares Corp.; c. Owner of 75% of stock in State of Granite, LLC.

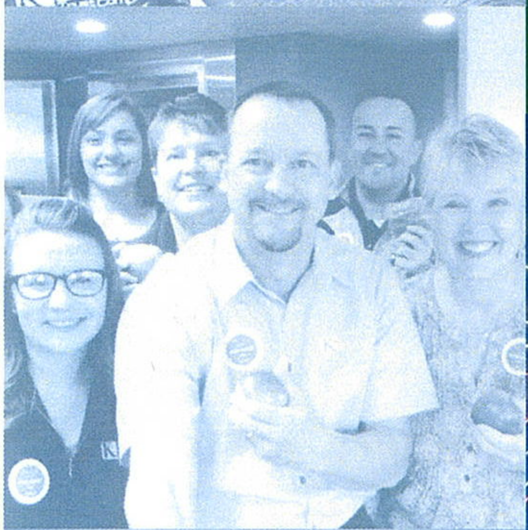
1. Name & Address: **Jon J. Prescott,** Houlton, ME/USA
2. Principal Occupation: Bank Executive
3. Title/Position: a. President & CEO, and Director of Katahdin Bankshares Corp., b. Director, President & CEO of Katahdin Trust Company, c. Director of MMG Insurance & Holding Company
4. % of each class: Owner of 1.80% of stock in Katahdin Bankshares Corp.

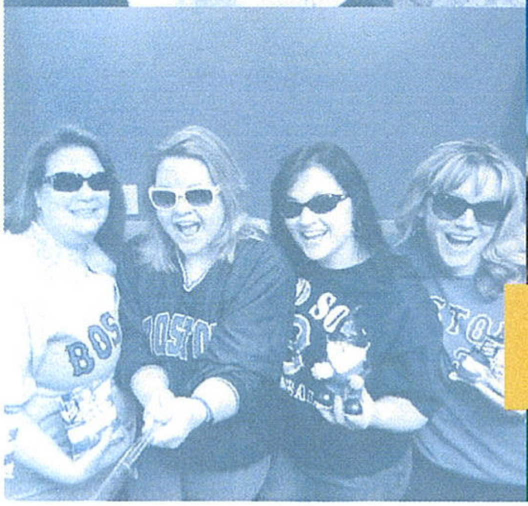
**Officers:**

1. Name & Address: **William P. Lucy**, Verona Island, ME/USA
2. Principal Occupation: Banker
3. Title/Position: No position with holding company, Executive Vice President, Commercial Services of Katahdin Trust Company
4. % of each class: Owner of .44% of stock in Katahdin Bankshares Corp.

1. Name & Address: **Bonnie C. Foster,** Houlton, ME/USA
2. Principal Occupation: Banker
3. Title/Position: No position with holding company, Executive Vice President, Retail Banking of Katahdin Trust Company
4. % of each class: Owner of .03% of stock in Katahdin Bankshares Corp.

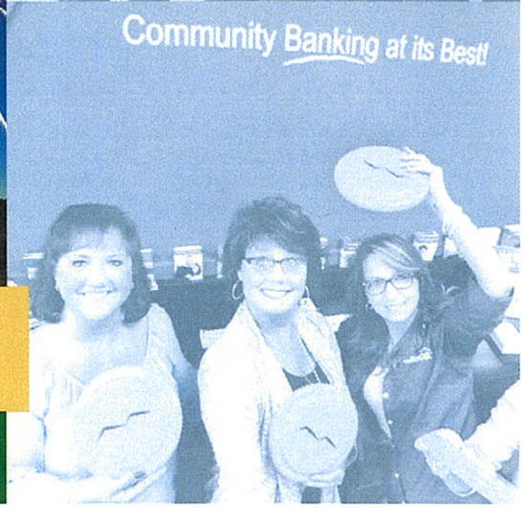
1. Name & Address: **Matthew M. Nightingale,** Houlton, ME/USA
2. Principal Occupation: Banker
3. Title/Position: a. Treasurer & Clerk of Katahdin Bankshares Corp., b. Executive Vice President, CFO, & Treasurer of Katahdin Trust Company
4. % of each class: Owner of .04% of stock of Katahdin Bankshares Corp.



Katahdin
Bankshares Corp.

# 2017




## ANNUAL REPORT

# TABLE OF CONTENTS



# CELEBRATING 100 YEARS!

2018 marks our 100th anniversary and we couldn't be more proud.

Katahdin Trust first opened its doors in the northern Maine town of Patten on March 7, 1918. Since then, we have grown to become 16 branches and more than 175 employees. Though the numbers have changed through the years, our core mission, values and vision remain true: to help make the communities we serve a better place to live, work and play.

We are forever grateful to our customers, employees and shareholders who have shown leadership in their communities and helped this region grow and prosper. When they succeed, so do we.

Over the last 100 years, we have seen a lot of changes in banking. Our dedicated, knowledgeable staff has adapted to new technology, increasing regulation and new expectations from our customers. Today, Katahdin Trust remains a local company, built on traditions of financial strength, community orientation and innovation. We are committed to offering the latest in products and services while striving to exceed our customers' expectations by getting to really know our customers and communities.

We thank you for being part of our journey and look forward to celebrating 100 years of community banking with you throughout 2018!

Community Banking at its Best! Since 1918.

PHOTO BY PAUL CYR

*Join us this year as we celebrate*

LEARN MORE AT **KATAHDINTRUST.COM/100YEARS**

100 YEARS

# DEAR FELLOW SHAREHOLDERS

Net income before dividends paid on preferred stock totaled $4,353,000, a reduction from the prior year's mark of $4,814,000. A significant tax adjustment was required at the end of the fourth quarter because of the Tax Cuts and Jobs Act of 2017. However, going forward, our tax rate will be greatly reduced, which will benefit shareholders. The total tax adjustment in 2017 was $438,000.

Net interest income rose for the year to $25,462,000, helped by strong loan growth early in the year. Non-interest income dropped slightly from $4,464,000 to $4,421,000.

As you know, management has been focusing on a few strategic initiatives, beginning with deposit growth. I am pleased to report that local deposits grew substantially in 2017, by $41,245,000. Local deposit growth is increasingly valuable as alternative wholesale funding costs have risen with three Federal Reserve rate hikes since December, 2016. Core deposit growth, especially regular checking accounts, is a major priority for the Bank in 2018.

Another area of focus is expense control. During 2017 total non-interest expenses were actually lower than the previous year. While that will not continue, we are focused on reducing our efficiency ratio over the next few years by eliminating any unnecessary costs and growing with greater operational efficiency. Technology will continue to play an important role in this effort.

Credit quality will be another point of emphasis in the coming years. A handful of larger relationships and general weakness in sectors of our portfolio such as the logging and related industries have led to high provisions for loan losses. We feel we can improve in this area which leads directly to bottom-line improvement.

For a detailed commentary on our financials, please refer to the section of this report entitled "Company Overview and Results of Operations."

After years of near-zero interest rates, upward movement has begun to take place. With the aforementioned interest rate hikes by the Fed, deposit costs have increased, particularly for wholesale funding. Rates for longer terms have increased as well, although not at the same pace as shorter term rates. This has the effect of flattening the yield curve, which continues to put pressure on

our net interest margin. Last year we were able to hold our margin fairly constant, and doing so again or even widening the margin, while a tall order, will be critical to increasing net interest income.

Since the passage of the Dodd Frank Act in 2010 community banks such as ours have been encumbered with increased regulatory burden as a result of the systemic risks posed by larger institutions. Regulations meant to affect the largest banks in the country have nonetheless "trickled down" to impact us. As this is written, activity in Congress to alleviate at least some of the most costly and time consuming burden is being considered. If this passes in some form it could have a benefit for the Company; however it is too soon to tell if legislation will be enacted.

In 2017 we launched a new online mortgage application service. This new technology allows customers to apply for a home loan outside normal business hours while still having access to the expertise of a local loan officer to help guide them through the process.

I am pleased to share with you that Katahdin Bankshares Corp. has been named to the 2018 OTCQX® Best 50, a ranking of top performing companies traded on the OTCQX Best Market for 2017. The OTCQX Best 50 is an annual ranking of the top 50 U.S. and international companies traded on the OTCQX market. The ranking is calculated based on an equal weighting of one-year total return and average daily dollar volume growth in the previous calendar year. Companies in the 2018 OTCQX Best 50 were ranked based on their performance in 2017. Katahdin Bankshares Corp.'s total return for 2017 including price appreciation and dividends was 27.5%.

I encourage you to complete and return your proxy for this year's annual meeting. Over the past few years many companies including Katahdin Bankshares Corp. have seen a lower level of voting by shareholders. Your votes are important to the Company; I hope that you will please take the time to review the proxy and vote by mail, telephone or online.

In closing, as I reflect on our 100th anniversary celebration in 2018, I am filled with gratitude for our employees and their contributions to our success. Each day I have the privilege of watching them fulfill our mission to serve the financial needs of our customers with superior service and attention to detail. In addition, they consistently demonstrate their commitment to our communities, volunteering nearly 8,000 hours of time to various organizations and causes in 2017.

Our success depends on our most important assets: our employees, our customers and you, our owners. We believe the best is yet to come and we thank you for being part of our journey as we enter our 100th year of community banking at its best.

Sincerely,

Jon J. Prescott
President & CEO

# OUR MISSION

Katahdin Trust Company's mission is to provide a broad range of financial services to Maine communities. In providing these services we will endeavor to achieve the highest level of customer satisfaction possible.

**WE ARE COMMITTED TO:**

- Providing quality financial service by giving each and every customer courteous, personal and professional attention. Our employees will be well trained; knowledgeable and motivated at all times to fulfill our customers' financial needs.
- Continued growth and increased shareholder value at levels in line with maintaining a strong capital position.
- Treating all people fairly and equally.
- Meeting the financial needs of the communities we serve, consistent with maintaining safe and sound banking practices.
- Remaining an independent, locally owned and managed community bank that adds to the quality of life of the communities we serve.
- Helping business grow and prosper.

**By adhering to our mission, Katahdin Trust Company will ensure that our customers, shareholders and employees alike will benefit from our continued growth and prosperity.**


KATAHDIN TRUST BRANCH IN PATTEN, MAINE

# OUR BOARD

### STEVEN L. RICHARDSON
**CHAIRMAN**
Partner, Richardson's True Value Hardware.
Patten, Maine. Director since 1978.

### RICHARD J. YORK, SR.
**VICE CHAIRMAN**
General Sales Manager, York's of Houlton.
Houlton, Maine. Director since 1997.

### JON J. PRESCOTT
**PRESIDENT & CEO**
Katahdin Bankshares Corp. and Katahdin Trust.
Houlton, Maine. Director since 1997.

### ROBERT E. ANDERSON
Chairman of the Board, FA Peabody Company.
Houlton, Maine. Director since 1989.

### PETER F. BRIGGS
Retired from the wholesale beverage industry.
Kennebunk, Maine. Director since 1995.

### RICHARD B. HARNUM, JR.
President, Webber Group.
Bangor, Maine. Director since 2017.

### KIMBERLEY A. NILES
Owner and Director, State of Granite, LLC.
Founder, VC CFO Services, LLC.
Plaistow, New Hampshire. Director since 2015.

### PAUL R. POWERS
Owner, Powers Roofing & Sheet Metal, Inc.
Owner, B.J.J. Powers Enterprises.
Caribou, Maine. Director since 2000.

## IN REMEMBRANCE

We were deeply saddened by the passing of Arthur L. Shur in 2017. Arthur became a Director in 1983 and dedicated 34 years to Katahdin Trust, serving as Vice Chairman from 1995 until 2013. He was a friend, mentor and trusted advisor. We will miss Arthur for his steady leadership and commitment to the interests of the Bank and its customers. Retired from the farming industry, Arthur lived in Island Falls, Maine with his wife, Brenda.

In recognition of his countless contributions to Katahdin Trust Company's prosperity and growth for more than three decades, we humbly dedicate the 2017 Annual Report to Arthur Shur.

# OUR EMPLOYEES

### SENIOR MANAGEMENT

**Jon J. Prescott**
President & CEO
**Bonnie C. Foster**
Executive Vice President
Retail Services
**William P. Lucy**
Executive Vice President
Commercial Services
**Matthew M. Nightingale**
Executive Vice President
Treasurer & CFO

### OFFICERS

**Tori A. Barber**
Branch Manager &
Retail Services Officer, Mars Hill
**Annette J. Beaton**
Vice President, Branch Manager &
Retail Services Officer, Houlton
**Vicki L. Bessette**
Vice President
Commercial Services Officer
**Cindy L. Boot**
Commercial Services Officer
**Fred A. Brown**
Vice President
Commercial Services Officer
**Cale L. Burger**
Vice President
Commercial Services Officer
**Angela T. Butler**
Senior Vice President
Commercial Services Officer
**David H. Cambridge**
Senior Vice President
Commercial Services Officer
**Aaron J. Cannan**
Senior Vice President
Commercial Services Officer
**Robert J. Cawley**
Assistant Vice President
Senior Credit Analyst
**Karen L. Chapman**
Vice President
Training Manager
**Albert "Joe" Clukey II**
Assistant Vice President
Retail Services Officer
**Jennifer L. Craig**
Branch Manager &
Retail Services Officer, Fort Fairfield
**Janet M. Doak**
Branch Manager &
Retail Services Officer, Ashland
**Sunny G. Flannery**
Branch Manager &
Retail Services Officer, Hampden
**Angela M. Franck**
Assistant Vice President
Branch Manager &
Retail Services Officer,
Fort Kent & Eagle Lake
**John S. Frohock**
Vice President,
Managed Assets Officer
**Brian J. Gardiner**
Senior Vice President
Commercial Services Officer
**Leslie M. Gardner**
Vice President, Retail Loans
**Allissa M. Given**
Branch Manager &
Retail Services Officer, Patten
**Katherine Z. Goodwin**
Project Manager
**Alison N. Gould**
Commercial Services Officer
**Diane W. Green**
Vice President, Branch Manager &
Retail Services Officer, Presque Isle
& Scarborough
**Billi B. Griffeth**
Assistant Vice President
Retail Services
**Patricia A. Hersey**
Vice President
Business Development Officer
**Katherine H. Hill**
Assistant Vice President
Bank Operations Manager
**Susan B. Lunn**
Vice President
Compliance Officer
**Valerie J. Maynard**
Senior Commercial Services Assistant
**Natasha R. McCarthy**
Human Resources Director
**Jean E. Noyes**
Vice President
Information Security Officer
**Kevin B. Plourde**
Senior Vice President
Credit Administration
**Joseph M. Porter**
Vice President
Controller
**Andrew L. Putnam**
Vice President
Chief Information Officer
**Krista K. Putnam**
Vice President
Marketing
**Sherry L. Roberts**
Vice President
Business Development Officer
**Debra K. Schillinger**
Branch Manager &
Retail Services Officer, Oakfield
& Island Falls
**Sarah S. Silliboy**
Assistant Vice President
BSA Officer
**Peggy S. Smith**
Assistant Vice President
Branch Manager &
Retail Services Officer,
Caribou & Van Buren
**Rebecca J. Smith**
Branch Manager &
Retail Services Officer, Bangor
**Vicki J. Smith**
Executive Assistant
**Craig C. Staples**
Vice President
Commercial Services Officer
**Pamela J. Ward**
Assistant Vice President
Credit Control
**Danelle L. Weston**
Regional Vice President
Bangor Market

Ashley M. Andrews
Michelle L. Bagley
Jennifer L. Blaisdell
Rhonda A. Blanchette
Lauren E. Bragan
Eva C. Brown
Jessica L. Buckley
Emily S. Bulley
Susan W. Cameron
Monica L. Campbell
Julie A. Chamberlain
Kelsey P. Charette
Wendy L. Clark
Samuel S. Clockedile
Susan M. Cone
Jane F. Conlogue
Lindsay M. Corey
Tabitha J. Corey
Clarissa H. Crandall
Debra L. Cyr
Melissa A. Dahlgren
Shelby A. Damboise
Kati Deane-Grant
Tory J. Delano
Carol A. Dow
Constance R. Drake
Cindy L. Drew
Lynn C. Dumond
Kimberly J. Embelton
April D. Emery
Kelly J. Emery
Sue A. Fox
Frederick E. Gagnon
Sarah J. Gardiner
Penny M. Garnett
Crystal A. Gastia
Loni R. Giberson
Vincent M. Gilmore
Jonathan P. Glazier
Julie A. Glidden
Candice L. Glover
Myka D. Graham
Lesia R. Grooms
Lorraine M. Guiggey
Cathy J. Haley

Trecia M. Hanning
Virginia L. Hartin
Wendy L. Henderson
Diane M. Hewett
Joshua D. Hitchcock
Sheila D. Hosford
Debra L. Jacques
Janet L. Jandreau
Lisa M. Jandreau
Julie M. Kaelin
Kelly J. Kilcollins
Jennifer L. King
Janet L. Lane
Rosemary A. Langer
Yancy J. LaPointe
Dawn M. Larrabee
Denise G. Lease
Hannah E. Lee
Crystal E. Levesque
Teresa S. Lincoln
Nicole L. Lockhart
Tannis B. Lundin
Jeremy K. MacArthur
Karen L. MacDonald
Joshua L. MacFarline
Ann M. Madore
Lita A. Madore
Brian A. Martin
Chelsea M. Martin
Eunice M. McAfee
Arianna E. McGraw
Shelly L. McHatten
Elizabeth M. Michaud
Susan M. Miller
Whitney J. Moran
Timothy D. Morris
Lori J. Nadeau
Rhonda M. Nicholson
Julie A. O'Hara
Connie M. Ouellette
Madison H. Outing
Robin M. Palmer
Whitney M. Palmer
Crystal L. Parent
Valerie J. Pelletier

Timothy W. Perry
Rebecca L. Potter
Deborah L. Powers
Kenneth F. Prescott
Mari E. Remeschatis
Jasmine M. Rockwell
Scott A. Rossignol
Courtney A. Sargent
Janet L. Saucier
Richard H. Schmidt III
Jana L. Shaw
Tyler P. Sherman
Abagale L. Stewart
Heidi J. Stewart
Dianne M. Tapley
Katelynn N. Tardie-Cyr
Kathy A. Thompson
Vickey J. Tilley
Lana J. Tucker
Amy L. Turner
Marie D. Vincent
Jolene L. Wallace
Kristen V. West
Lauren E. West
Susan M. White
Lisa M. Willigar
Miranda B. Wotton
Crystal L. Wright
Emerson M. Wright
Mindi A. Yates

### MAINE FINANCIAL GROUP

**W. Scott Dillon**
President
**James P. Amabile**
Vice President
Commercial Services Officer
**Susan L. McCarthy**
Vice President
Commercial Services Officer

Christopher C. Case
Devin J. Rolph
Tamara J. Wheeler

### KATAHDIN FINANCIAL SERVICES

**Bradley A. Berthiaume**
Vice President
Financial Consultant

Adam R. Bither
Kelly Jo Cole

Communities that **work together thrive** together.

**7,800**
VOLUNTEER HOURS

**230**
LOCAL NON-PROFITS

# COMPANY OVERVIEW AND RESULTS OF OPERATIONS

Katahdin Bankshares Corp. ("KBS" or the "Company") is a bank holding company, incorporated under the laws of the State of Maine in 1986 for the purpose of becoming the parent holding company of Katahdin Trust Company (the "Bank"). As of December 31, 2017, KBS had consolidated total assets of $794.6 million, total deposits of $647.8 million, and total shareholders' equity of $66.8 million. Following is an overview of the Company, its strategy, and the results of 2017 operations.

**Our Business**
Established in 1918 and celebrating 100 years of service, the Bank provides a full line of banking services to individuals and businesses throughout Maine and online at KatahdinTrust.com.

The Bank conducts commercial and retail banking business that includes accepting deposits from the general public and utilizing those funds to originate commercial loans, commercial and residential real estate loans, and consumer loans. The Bank offers a wide range of business and personal banking services, including checking and savings accounts, money market accounts, certificates of deposits, and the convenience of debit cards, telephone banking, ATMs, online banking and bill payment, mobile and text banking, online account opening, and eCheck Deposit, a service which enables the customer to make remote deposits electronically.

Securities and insurance products are made available to the Bank's customers through Katahdin Financial Services in partnership with a third party registered broker-dealer, with assets under management of $105.3 million as of December 31, 2017.

The Bank derives its income primarily from interest and fees earned on loans and investments and service charges and fees on deposit accounts. Its expenses consist primarily of interest paid on deposits and borrowed funds and operating expenses.

**Our Strategy**
The Bank's goals include continuing as a leading financial institution throughout Maine. The Bank explores opportunities for profitable growth and expansion while seeking ways to increase net interest income, enhance non-interest income, while controlling operating costs, with the goal of maximizing long-term returns to our shareholders.

The Bank's goal is to have a well-rounded loan portfolio which is served by an experienced team with the expertise to meet customer needs throughout the Bank's market area. The Bank has a strong commitment to small business and has received the preferred lender designation from the U. S. Small Business Administration (SBA); a designation reserved for SBA's most experienced and trusted lenders with a proven record of small business lending performance and excellence; and in 2017 received the Outstanding Partner Award for originating a significant number of SBA guaranteed loans.

The Bank has a strong commitment to traditional community banking. The Bank's goal is to attract, as customers, small and medium sized businesses as well as individuals who wish to conduct business with a community bank that demonstrates an active interest in their businesses and communities. Our staff recognizes opportunities to offer additional products and services that will strengthen each customer relationship.

The Bank recognizes the importance of high quality customer service; its stated goal is to "Exceed Our Customers' Expectations". Management believes its ability to deliver products and services in a highly personalized manner with superior customer service sets the Bank apart from its competitors.

The Bank recognizes the changes in customer preference brought about through the use of various technology platforms, and seeks to deliver those technologies best suited to its customers in an effective and complementary way.

The foundation of the Bank's business strategy is its employees. The Bank's commitment to customer service enables us to attract and retain customer-focused employees with knowledge of and experience in the Bank's market area. The Bank's personnel reside in their respective market areas, know their customers, and are equipped to provide high quality service. The Bank's lenders are experienced in the financial services industry and have operated in the Bank's market area through different economic cycles and lending market conditions. The Bank encourages and supports management and staff to be active community volunteers. Every year the Bank's employees contribute significant hours to a variety of community organizations ranging from charitable to civic.

# SELECTED FINANCIAL DATA

The summary consolidated financial and other data should be read in conjunction with, and is qualified in its entirety by, the Company's current and prior years' annual reports and regulatory filings. Dollars in thousands, except share and per share data.

| As of or for the Years Ended December 31, | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| Balance Sheet Data | | | | | |
| Total assets | $ 794,638 | $ 754,012 | $ 702,289 | $ 667,112 | $ 646,287 |
| Total investments [1] | 90,445 | 88,965 | 74,836 | 60,597 | 57,506 |
| Total loans | 661,636 | 623,279 | 586,238 | 565,337 | 546,242 |
| Allowance for loan losses | (6,048) | (6,032) | (5,330) | (5,899) | (6,097) |
| Total deposits | 647,752 | 652,969 | 606,205 | 550,694 | 557,933 |
| Shareholders' equity | 66,799 | 64,415 | 62,357 | 71,086 | 58,961 |
| Summary of Operations | | | | | |
| Interest and dividend income | $ 30,803 | $ 29,350 | $ 27,512 | $ 27,031 | $ 26,517 |
| Interest expense | 5,341 | 4,281 | 3,861 | 4,240 | 4,712 |
| Net interest income | 25,462 | 25,069 | 23,651 | 22,791 | 21,805 |
| Provision for loan losses | 1,225 | 1,316 | 50 | 548 | 798 |
| Net interest income after the provision for loan losses | 24,237 | 23,753 | 23,601 | 22,243 | 21,007 |
| Non-interest income before impairment of investment securities | 4,421 | 4,464 | 3,884 | 3,568 | 3,409 |
| Net impairment of investment securities | 5 | 4 | 2 | 17 | 19 |
| Non-interest expense | 21,529 | 21,535 | 20,372 | 19,621 | 18,815 |
| Income before income taxes | 7,124 | 6,678 | 7,111 | 6,173 | 5,582 |
| Income taxes | 2,771 | 1,864 | 2,301 | 1,918 | 1,733 |
| Net income | $ 4,353 | $ 4,814 | $ 4,810 | $ 4,255 | $ 3,849 |
| Less dividends on preferred stock | 875 | 875 | 910 | 557 | 123 |
| Net income available to common shareholders | $ 3,478 | $ 3,939 | $ 3,900 | $ 3,698 | $ 3,726 |
| Per Common Shares and Common Shares Outstanding | | | | | |
| Net income, basic [2] | $ 1.03 | $ 1.16 | $ 1.15 | $ 1.09 | $ 1.09 |
| Net income, diluted [2] | 1.03 | 1.16 | 1.15 | 1.09 | 1.09 |
| Book value [3] | 16.94 | 16.17 | 15.47 | 14.93 | 14.09 |
| Tangible book value [3] | 15.24 | 14.48 | 13.80 | 13.26 | 12.41 |
| Weighted average common shares outstanding: [4] | | | | | |
| Basic | 3,737,220 | 3,399,826 | 3,404,367 | 3,404,367 | 3,400,505 |
| Diluted | 3,737,220 | 3,399,826 | 3,404,367 | 3,404,367 | 3,404,367 |
| Common shares outstanding at period end | 3,404,367 | 3,404,367 | 3,404,367 | 3,404,367 | 3,404,367 |
| Adjusted common shares outstanding at period end [5] | 3,361,298 | 3,380,173 | 3,404,367 | 3,404,367 | 3,404,367 |
| Selected Performance Ratios | | | | | |
| Return on average assets | 0.55% | 0.66% | 0.70% | 0.66% | 0.64% |
| Return on average common shareholders' equity | 6.17 | 7.23 | 7.50 | 7.44 | 7.81 |
| Net interest spread [6] | 3.33 | 3.56 | 3.62 | 3.66 | 3.75 |
| Net interest margin [7] | 3.42 | 3.66 | 3.71 | 3.78 | 3.89 |
| Efficiency ratio [8] | 72.06 | 72.93 | 73.99 | 74.42 | 74.62 |
| Asset Quality Ratios | | | | | |
| Allowance for loan losses to period end loans | 0.91% | 0.97% | 0.91% | 1.04% | 1.12% |
| Allowance for loan losses to non-performing loans [9] | 84.76 | 39.57 | 61.71 | 50.24 | 64.49 |
| Non-performing loans to period end loans [9] | 1.08 | 2.45 | 1.47 | 2.07 | 1.73 |
| Non-performing assets to total assets [10] | 0.95 | 2.11 | 1.31 | 1.83 | 1.50 |
| Capital Ratios (Katahdin Trust Company) | | | | | |
| Total risk-based capital ratio | 12.64% | 13.02% | 13.34% | 13.38% | 12.54% |
| Tier 1 risk-based capital ratio | 11.63 | 11.95 | 12.33 | 12.23 | 11.29 |
| Common equity tier 1 risk-based capital ratio | 11.63 | 11.95 | 12.33 | - | - |
| Tier 1 capital ratio (Leverage ratio) | 8.88 | 9.15 | 9.48 | 9.68 | 8.89 |
| Other Data | | | | | |
| Number of full and limited service banking offices | 16 | 19 | 19 | 19 | 18 |
| Number of full-time equivalent employees | 174 | 186 | 195 | 196 | 191 |
| Katahdin Financial Services Assets Under Management | $ 105,280 | $ 90,160 | $ 83,500 | $ 87,200 | $ 75,400 |

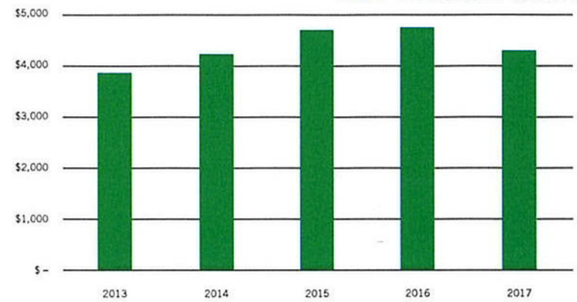
(1) Consists of investment securities and FHLB stock. (2) Computed based on the weighted average number of common shares outstanding during each period. (3) Book value and Tangible Book Value are calculated using Adjusted Common Shares Outstanding at period end. (4) Weighted Average Common Shares Outstanding less weighted average unallocated ESOP shares. Used for calculating Earnings per Common Share. (5) Common Shares Outstanding at period end less unallocated ESOP shares period end. Since unearned ESOP shares are deducted from capital, this adjustment deducts the unallocated shares from shares outstanding for calculating book value and tangible book value. (6) Net interest spread is the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities. (7) Net interest margin is the net interest income divided by the average interest-earning assets. (8) Efficiency ratio is non-interest expense divided by the sum of net interest income and non-interest income. (9) Non-performing loans consist of non-accrual loans and restructured loans, where applicable. (10) Non-performing assets consist of non-accrual loans, restructured loans, and foreclosed assets, where applicable.

# COMPANY OVERVIEW AND RESULTS OF OPERATIONS

### Net Income

Net Income before preferred stock dividends reached $4,353,000 in 2017. When adding back a one-time tax adjustment stemming from the Tax Cuts and Jobs Act of 2017, Net Income would have been $4,791,000 which is slightly behind last year's level of $4,814,000. Other non-recurring factors contributing to lower net income in 2017 vs. 2016 include a recovery of interest income in 2016 that totaled $749,000 not repeated in 2017 and branch closure costs totaling $285,000. If accounting for these one-time items, Net Income on a run-rate basis would have been greater in 2017 than 2016.

**NET INCOME** ($000)




Diluted earnings per common share totaled $1.03 per share, down from $1.16 per share for reasons previously mentioned. Return on Average Assets ended at 0.55% compared to 0.66% in 2016. Return on Average Common Equity was 6.17% as compared to 7.23% in 2016.

### Net Interest Income

Net interest income reached $25,462,000, exceeding the prior year by $393,000 or 1.6%. Looking further at run rate growth due to the 2016 recovered interest mentioned above, core net interest income grew by 4.7% in 2017 or $1,142,000. Net interest income reflects revenues generated through income from earning assets plus loan fees, less interest paid on interest-bearing deposits and borrowings.

The Company's average net interest spread was 3.33% in 2017, compared to the prior year average spread of 3.56%. Importantly however, our net interest spread of 3.33% reflects both where the year started and the year to date average, showing some stabilization throughout 2017. While the flat yield curve has further developed and remained throughout 2017, managing through the next rate cycle with a solid margin is a top priority.

### Provision and Asset Quality

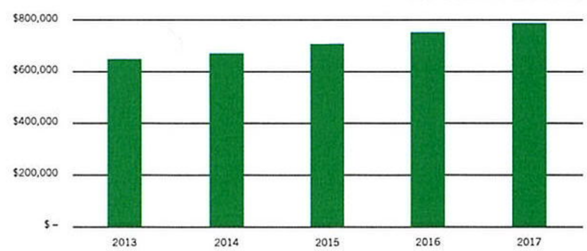
We're pleased to have shown a big improvement in asset quality numbers at year end compared to prior year. This is mainly due to the resolution of a large credit in the fourth quarter. Overall asset quality is sound. Non-performing loans to period end loans ended the year at 1.08%, a decrease from 2.45% at the end of 2016. Non-performing assets to total assets ended the year at 0.95%, down from 2.11% at year-end 2016.

The allowance for loan loss was funded with a provision of $1,225,000 in 2017, down by $91,000 from last year. As a result, our allowance for loan losses to period end loans ratio ended at 0.91% as compared to 0.97% at year end 2016. Management continuously monitors the Bank's reserve for loan losses compared to asset quality in order to match our reserves with a reasonable estimate of risk. Detailed information regarding our allowance for loan loss can be found in the footnotes to the audited financial statements.

### Non-Interest Income and Expense

Non-interest income totaled $4,421,000, a slight decrease of $43,000 from 2016. Non-interest income consists largely of service charges on loans, deposits, and electronic banking activity. The Bank continued to have good success with service and interchange fee income as well as generating revenues from interest rate swaps put in place with commercial real estate loan customers.

**ASSETS** ($000)




Non-interest expense dropped by $6,000 to $21,529,000. The Bank has implemented strategies to reduce overhead expenses throughout 2017 which have begun to yield results. Non-interest expense included a one-time branch closure cost of $285,000 mentioned above. Other increases over last year included an additional FDIC premium of $87,000 due to a change in the calculation for assessing fees on brokered deposits. We're pleased that solid deposit growth and a shift to less costly borrowings have helped us nearly eliminate this extra assessment. Further, elevated debit card fraud in early 2017 totaled $51,000 over last year. Because of enhanced monitoring introduced during the year, these losses have been mitigated since that point.

Key management goals have been to find operating efficiencies where possible, as well as searching for revenue generation.

# COMPANY OVERVIEW AND RESULTS OF OPERATIONS

### Assets

Total assets reached $794,638,000, an increase over the prior year of $40,626,000 or 5.4%. Asset growth was achieved from a mix of loan growth and investment growth. The investment portfolio ended the year at $90,445,000, representing an increase of $1,480,000 over 2016.

### Loans

Total loans increased to $661,636,000, rising $38,357,000 or 6.2% year over year. Much of our growth last year was in the Commercial real estate loan category which increased by $34.6 million to a portfolio balance of $331,373,000. Commercial equipment loans totaled $164,431,000 and grew by $3.4 million. Residential 1- 4 family loans grew $1 million to a portfolio level of $141,429,000. Approximately 76% of the Bank's loan portfolio consists of municipal, commercial and commercial real estate loans.

### Deposits

Local deposits grew significantly in 2017. While total deposits were down by $5.2 million to $647,752,000, this represents a large reduction of brokered deposit funding that was replaced by local deposit funding of $41,245,000. Growth has come from local deposit initiatives throughout our market area. Local deposits increased in all areas of checking, savings, money markets and CD's. Offsetting some of the brokered deposit reduction was an increase in secured borrowings from the Federal Home Loan Bank (FHLB) and other sources totaling $44,689,000. This change in funding strategy allowed us to significantly reduce our reliance on brokered deposits. After accounting for this shift, local deposit growth funded all of the Bank's loan growth in 2017.

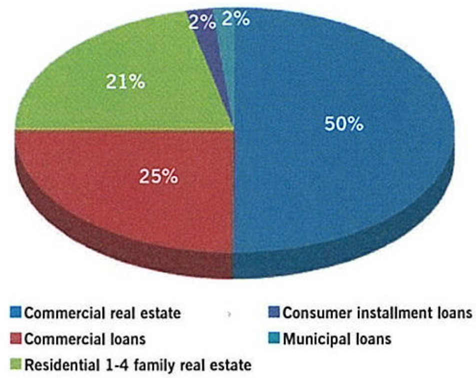
Brokered CDs and secured borrowings enable the Bank to fund asset growth when our ability to grow local deposits at any given time does not keep pace with loan growth opportunities. These alternative funding sources provide the Bank flexibility with term structures in order to appropriately balance interest rate risk positions as needed.

### Capital

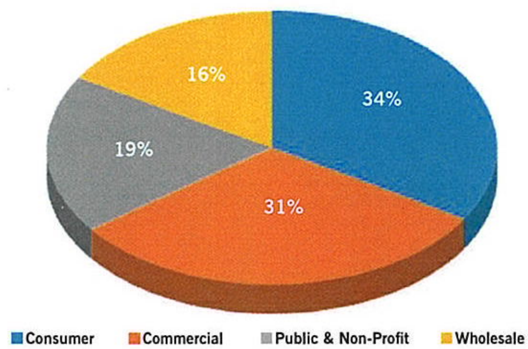
Total Shareholders' Equity stood at $66,799,000, an increase of $2,384,000 from year end 2016. Capital ratios for the Bank remain well above the minimums to be well-capitalized per regulatory capital requirements. The Bank's leverage ratio at year-end 2017 was 8.88%, compared to 9.15% at the end of 2016. Total risk-based capital stood at 12.64% as compared to 13.02% in 2016.

Tangible book value of $15.24 was an increase of $0.76 or 5.2% over year end 2016. The Company paid out a total of $0.40 per share in common stock dividends representing a 38.8% payout ratio of 2017 net income available to common shareholders.

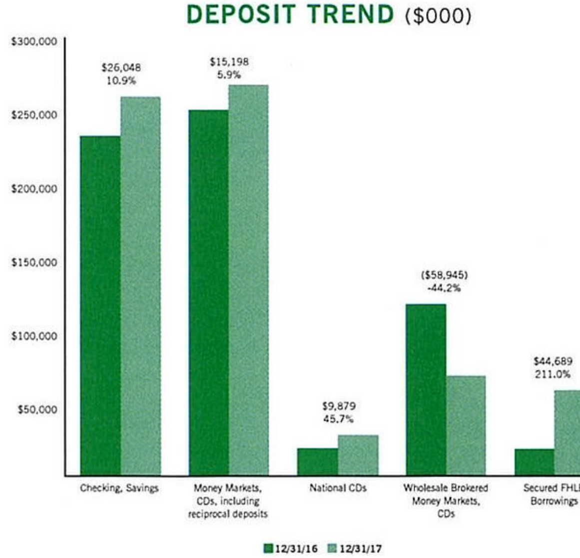
**LOAN MIX**




**DEPOSIT SOURCES**




**DEPOSIT TREND** ($000)



# INDEPENDENT AUDITOR'S REPORT

BerryDunn

Board of Directors and Shareholders
Katahdin Bankshares Corp. and Subsidiary

We have audited the accompanying consolidated financial statements of Katahdin Bankshares Corp. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

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

**Auditor's Responsibility**
Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

**Opinion**
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Katahdin Bankshares Corp. and Subsidiary as of December 31, 2017 and 2016, and the consolidated results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

Berry Dunn McNeil & Parker, LLC

Bangor, Maine
February 14, 2018

# CONSOLIDATED BALANCE SHEETS

**December 31, 2017 and 2016**

| ASSETS | 2017 | 2016 |
|---|---|---|
| Cash and due from banks | $ 7,895,000 | $ 6,450,000 |
| Interest bearing deposits in banks | 6,089,000 | 4,873,000 |
| Securities available-for-sale | 86,872,000 | 87,271,000 |
| Securities held-to-maturity | 9,000 | 12,000 |
| Federal Home Loan Bank stock, at cost | 3,564,000 | 1,682,000 |
| Loans receivable, net of allowance for loan losses of $6,048,000 in 2017 and $6,032,000 in 2016 | 655,588,000 | 617,247,000 |
| Bank premises and equipment, net | 11,049,000 | 12,162,000 |
| Goodwill | 5,559,000 | 5,559,000 |
| Other assets | 18,013,000 | 18,756,000 |
| | $ 794,638,000 | $ 754,012,000 |

| LIABILITIES AND SHAREHOLDERS' EQUITY | 2017 | 2016 |
|---|---|---|
| Deposits | | |
| Demand deposits | $ 114,730,000 | $ 102,851,000 |
| NOW and money market deposits | 275,938,000 | 267,384,000 |
| Savings deposits | 63,568,000 | 58,817,000 |
| Certificates of deposit $250,000 and over | 97,704,000 | 137,183,000 |
| Other certificates of deposit | 95,812,000 | 86,734,000 |
| Total deposits | 647,752,000 | 652,969,000 |
| Advances from Federal Home Loan Bank | 65,867,000 | 21,178,000 |
| Other borrowed funds | 118,000 | 889,000 |
| Accrued expenses and other liabilities | 6,885,000 | 7,344,000 |
| Junior subordinated debentures | 7,217,000 | 7,217,000 |
| Total liabilities | 727,839,000 | 689,597,000 |
| Shareholders' equity | | |
| Preferred stock, 20,000 shares authorized Series D, 4,000 shares issued and outstanding | 9,859,000 | 9,766,000 |
| Common stock, $.10 par value; 20,000,000 shares authorized, 3,404,367 shares issued and outstanding on December 31, 2017 and 2016 | 339,000 | 339,000 |
| Surplus | 8,778,000 | 8,778,000 |
| Undivided profits | 49,141,000 | 46,980,000 |
| Accumulated other comprehensive loss | | |
| Net unrealized depreciation on securities available-for-sale, net of deferred income taxes | (778,000) | (856,000) |
| Net unrealized gain (loss) on derivative instruments, net of deferred income taxes | 17,000 | (319,000) |
| Unearned ESOP shares | (557,000) | (273,000) |
| Total shareholders' equity | 66,799,000 | 64,415,000 |
| | $ 794,638,000 | $ 754,012,000 |

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

# CONSOLIDATED STATEMENTS OF INCOME

**Years Ended December 31, 2017 and 2016**

| | 2017 | 2016 |
|---|---|---|
| Interest and dividend income | | |
| Loans | $ 28,702,000 | $ 27,558,000 |
| Investment securities | 2,093,000 | 1,783,000 |
| Other interest-earning assets | 8,000 | 9,000 |
| Total interest and dividend income | 30,803,000 | 29,350,000 |
| Interest expense | | |
| Deposits | 4,464,000 | 3,778,000 |
| Borrowed funds and junior subordinated debentures | 877,000 | 503,000 |
| Total interest expense | 5,341,000 | 4,281,000 |
| Net interest income | 25,462,000 | 25,069,000 |
| Provision for loan losses | 1,225,000 | 1,316,000 |
| Net interest income after provision for loan losses | 24,237,000 | 23,753,000 |
| Noninterest income | | |
| Service charges and fees | 1,968,000 | 1,862,000 |
| Realized gain on sale of securities available-for-sale | - | 59,000 |
| Other | 2,453,000 | 2,543,000 |
| Total noninterest income before impairment of investment securities | 4,421,000 | 4,464,000 |
| Total other-than-temporary impairment losses | (9,000) | (16,000) |
| Portion of loss recognized in other comprehensive income | 4,000 | 12,000 |
| Net impairment losses recognized in net income | (5,000) | (4,000) |
| Net noninterest income | 4,416,000 | 4,460,000 |
| Noninterest expenses | | |
| Salaries and employee benefits | 12,594,000 | 12,993,000 |
| Net occupancy expense | 1,566,000 | 1,617,000 |
| Furniture and equipment expense | 1,753,000 | 1,796,000 |
| Data processing | 1,281,000 | 1,242,000 |
| Marketing | 792,000 | 783,000 |
| FDIC deposit assessment | 648,000 | 561,000 |
| Other general and administrative | 2,895,000 | 2,543,000 |
| Total noninterest expenses | 21,529,000 | 21,535,000 |
| Income before income taxes | 7,124,000 | 6,678,000 |
| Income tax expense | 2,771,000 | 1,864,000 |
| Net income | $ 4,353,000 | $ 4,814,000 |
| Less dividends on preferred stock | $ 875,000 | $ 875,000 |
| Net income available to common shareholders | $ 3,478,000 | $ 3,939,000 |
| Basic earnings per common share | $ 1.03 | $ 1.16 |
| Diluted earnings per common share | $ 1.03 | $ 1.16 |
| Diluted weighted average common shares outstanding | 3,373,220 | 3,399,826 |



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

# CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

**Years Ended December 31, 2017 and 2016**

| | 2017 | 2016 |
|---|---|---|
| Net income | $ 4,353,000 | $ 4,814,000 |
| Other comprehensive income (loss), net of related tax effects | | |
| Unrealized appreciation (depreciation) on available-for-sale securities | | |
| Unrealized appreciation (depreciation) on available-for-sale securities arising during period | 307,000 | (1,077,000) |
| Reclassification adjustment for (gains) losses realized in net income | 5,000 | (55,000) |
| Tax effect | (106,000) | 385,000 |
| Net change in unrealized depreciation on available-for-sale securities, net of tax | 206,000 | (747,000) |
| Unrealized gain on derivative instruments, net of tax | 334,000 | 499,000 |
| Total other comprehensive income (loss) | 540,000 | (248,000) |
| Comprehensive income | $ 4,893,000 | $ 4,566,000 |

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

# CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

**Years Ended December 31, 2017 and 2016**

| | Preferred Stock | Common Stock | Surplus | Undivided Profits | Net Unrealized Depreciation on Securities | Net Unrealized Gain (Loss) on Derivative Instruments | Unearned ESOP Shares | Total |
|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2015 | $ 9,673,000 | $ 339,000 | $ 8,776,000 | $ 44,496,000 | $ (109,000) | $ (818,000) | $ - | $ 62,357,000 |
| Net income | - | - | - | 4,814,000 | - | - | - | 4,814,000 |
| Change in net unrealized depreciation on securities available-for-sale, net of deferred income taxes of $(385,000) | - | - | - | - | (747,000) | - | - | (747,000) |
| Change in net unrealized loss on derivative instruments, at fair value, net of taxes of $257,000 | - | - | - | - | - | 499,000 | - | 499,000 |
| Total comprehensive income | - | - | - | 4,814,000 | (747,000) | 499,000 | - | 4,566,000 |
| Cash dividends declared on common stock, $0.40 per share | - | - | - | (1,362,000) | - | - | - | (1,362,000) |
| Accretion on preferred stock issuance | 93,000 | - | - | (93,000) | - | - | - | - |
| Cash dividends declared on preferred stock | - | - | - | (875,000) | - | - | - | (875,000) |
| Shares purchased by ESOP (25,500 shares) | - | - | - | - | - | - | (287,000) | (287,000) |
| Common stock held by ESOP committed to be released (1,306 shares) | - | - | 2,000 | - | - | - | 14,000 | 16,000 |
| Balance, December 31, 2016 | 9,766,000 | 339,000 | 8,778,000 | 46,980,000 | (856,000) | (319,000) | (273,000) | 64,415,000 |
| Net income | - | - | - | 4,353,000 | - | - | - | 4,353,000 |
| Change in net unrealized depreciation on securities available-for-sale, net of deferred income taxes of $106,000 | - | - | - | - | 206,000 | - | - | 206,000 |
| Change in net unrealized gain on derivative instruments, at fair value, net of taxes of $171,000 | - | - | - | - | - | 334,000 | - | 334,000 |
| Total comprehensive income | - | - | - | 4,353,000 | 206,000 | 334,000 | - | 4,893,000 |
| Cash dividends declared on common stock, $0.40 per share | - | - | - | (1,350,000) | - | - | - | (1,350,000) |
| Accretion on preferred stock issuance | 93,000 | - | - | (93,000) | - | - | - | - |
| Reclassification adjustment for effect of enacted tax law changes | - | - | - | 126,000 | (128,000) | 2,000 | - | - |
| Cash dividends declared on preferred stock | - | - | - | (875,000) | - | - | - | (875,000) |
| Shares purchased by ESOP (27,000 shares) | - | - | - | - | - | - | (371,000) | (371,000) |
| Common stock held by ESOP committed to be released (8,125 shares) | - | - | - | - | - | - | 87,000 | 87,000 |
| **Balance, December 31, 2017** | $ 9,859,000 | $ 339,000 | $ 8,778,000 | $ 49,141,000 | $ (778,000) | $ 17,000 | $ (557,000) | $ 66,799,000 |



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

# CONSOLIDATED STATEMENTS OF CASH FLOWS

**Years Ended December 31, 2017 and 2016**

| | 2017 | 2016 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income | $ 4,353,000 | $ 4,814,000 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization | 1,921,000 | 1,849,000 |
| Net amortization of securities | 276,000 | 231,000 |
| Provision for loan losses | 1,225,000 | 1,316,000 |
| Provision for losses on other real estate owned | 48,000 | 29,000 |
| Amortization of investments in limited partnerships | 69,000 | 69,000 |
| Impairment of investment securities | 5,000 | 4,000 |
| Gain on sale of securities available-for-sale | - | (59,000) |
| Deferred income tax provision | 154,000 | 514,000 |
| Increase in cash value of life insurance | (330,000) | (309,000) |
| Loss on sale of other real estate and property owned | 212,000 | 41,000 |
| ESOP compensation expense | 87,000 | 16,000 |
| Decrease in accrued income receivable and other assets | 297,000 | 540,000 |
| (Decrease) increase in accrued expenses and other liabilities | (350,000) | 227,000 |
| Net cash provided by operating activities | 7,967,000 | 9,282,000 |
| Cash flows from investing activities | | |
| Additions to premises and equipment | (504,000) | (385,000) |
| Loan originations and principal collections, net | (39,858,000) | (38,205,000) |
| Purchase of securities available-for-sale | (11,178,000) | (28,631,000) |
| Maturities of securities available-for-sale | 11,608,000 | 10,149,000 |
| Maturities of securities held-to-maturity | 3,000 | 4,000 |
| Proceeds from sales of other real estate and property owned | 400,000 | 444,000 |
| Redemption of FHLB stock | 308,000 | 1,405,000 |
| Purchase of FHLB stock | (2,190,000) | (768,000) |
| Proceeds from sale of securities available-for-sale | - | 2,404,000 |
| Purchase of bank-owned life insurance | - | (1,500,000) |
| Net cash used by investing activities | (41,411,000) | (55,083,000) |
| Cash flows from financing activities | | |
| Net (decrease) increase in deposits | (5,217,000) | 46,764,000 |
| Net (decrease) increase in securities sold under agreements to repurchase | (771,000) | 349,000 |
| Net increase in short-term borrowings | 64,700,000 | 21,000,000 |
| Repayment of long-term debt | (20,011,000) | (20,010,000) |
| Cash dividends paid on preferred stock | (875,000) | (875,000) |
| Cash dividends paid on common stock | (1,350,000) | (1,362,000) |
| Cash provided to ESOP for purchase of shares | (371,000) | (287,000) |
| Net cash provided by financing activities | 36,105,000 | 45,579,000 |
| Net increase (decrease) in cash and cash equivalents | 2,661,000 | (222,000) |
| Cash and cash equivalents, beginning of year | 11,323,000 | 11,545,000 |
| Cash and cash equivalents, end of year | $ 13,984,000 | $ 11,323,000 |
| Supplementary cash flow information: | | |
| Interest paid on deposits and borrowed funds | $ 5,270,000 | $ 4,255,000 |
| Income taxes paid | 2,405,000 | 2,041,000 |
| Noncash transactions | | |
| Transfer from loans to other real estate and property owned | 292,000 | 550,000 |
| Preferred stock dividends declared but not paid | 219,000 | 219,000 |

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

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**December 31, 2017 and 2016**

## Nature of Business

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

## 1. Summary of Significant Accounting Policies

### Basis of Presentation and Consolidation

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

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

### Use of Estimates

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

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

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

### Cash and Cash Equivalents

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

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

### Securities

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

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

### Loans and Allowance for Loan Losses

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

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

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

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

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

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

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

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

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

### Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend

## 1. Summary of Significant Accounting Policies (cont.)

credit, including commitments under credit card arrangements, commercial letters-of-credit, and standby letters-of-credit. Such financial instruments are recorded when they are funded.

### Other Real Estate and Property Owned (OREO)

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

### Bank Premises and Equipment

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

### Goodwill

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

### Income Taxes

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

ASC Topic 740, *Income Taxes*, defines the criteria that an individual tax position must satisfy for some or all of the benefits of that position to be recognized in a company's financial statements. ASC Topic 740 prescribes a recognition threshold of more-likely-than-not, and a measurement attribute for all tax positions taken or expected to be taken on a tax return, in order for those tax positions to be recognized in the financial statements. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the years ended December 31, 2014 through 2016.

### Comprehensive Income

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

### Employee Stock Ownership Plan

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

### Earnings Per Share

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

### Derivative Financial Instruments Designated as Hedges

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

### Recently Issued Accounting Pronouncements

In January 2016, FASB issued Accounting Standards Update (ASU) No. 2016-01, *Financial Instruments - Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. The ASU was issued to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This ASU changes how entities account for equity investments that do not result in consolidation and are not accounted for under the equity method of accounting. The ASU also changes certain disclosure requirements and other aspects of GAAP, including a requirement for public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The ASU will not have a material effect on the Company's consolidated financial statements.

In February 2016, FASB issued ASU No. 2016-02, *Leases*. The ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The ASU is effective for fiscal years beginning after December 15, 2018. Management is reviewing the guidance in the ASU to determine whether it will have a material effect on the Company's consolidated financial statements.

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

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

In January 2017, FASB issued ASU No. 2017-04, *Intangibles, Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU was issued to reduce the cost and complexity of the goodwill impairment test. To simplify the subsequent measurement of goodwill, step two of the goodwill impairment test was eliminated. Instead, a Company will recognize an impairment of goodwill should the carrying value of a reporting unit exceed its fair value (i.e. step one). The ASU is effective for fiscal years beginning after

## 1. Summary of Significant Accounting Policies (cont.)

December 15, 2020 and will be applied prospectively. Management does not expect the ASU will have a material effect on the Company's consolidated financial statements.

In March 2017, FASB issued ASU No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*. This ASU shortens the amortization period for the premium on certain purchased callable debt securities to the earliest call date. Today, entities generally amortize the premium over the contractual life of the security. The new guidance does not change the accounting for purchased callable debt securities held at a discount; the discount continues to be amortized to maturity. The ASU is effective for fiscal years beginning after December 15, 2018; early adoption is permitted. The guidance calls for a modified retrospective transition approach under which a cumulative-effect adjustment will be made to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. Management does not expect the ASU will have a material effect on the Company's consolidated financial statements.

In May 2017, FASB issued ASU No. 2017-09, *Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting*. The ASU was issued to provide clarity and reduce both 1) diversity in practice and 2) cost and complexity when applying the guidance in Topic 718, Compensation-Stock Compensation, to a change to the terms or conditions of a shared-based payment award. The ASU includes guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The ASU is effective for the annual period, and interim periods within the annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period. The ASU should be applied prospectively to an award modified on or after the adoption date. The ASU will not have a material effect on the Company's consolidated financial statements.

In August 2017, FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815)*. The amendments in this ASU improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition, this ASU makes certain targeted improvements to simplify the application of the hedge accounting guidance in current GAAP. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018. Early application is permitted in any interim period after issuance of the ASU. Management does not expect the ASU will have a material effect on the Company's consolidated financial statements.

In February 2018, FASB issued AU No. 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. This ASU was issued to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. Consequently, the amendments eliminate the stranded tax effects resulting from the Tax Cuts and Jobs Act and will improve the usefulness of information reported to financial statement users. However, because the amendments only relate to the reclassification of the income tax effects of the Tax Cuts and Jobs Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The ASU is effective for fiscal years beginning after December 15, 2018, with early adoption permitted for financial statements which have not yet been issued. The Company adopted the ASU for the December 31, 2017 consolidated financial statements and made the required disclosures regarding stranded tax effects.

## 2. Cash and Due from Banks

The Bank is required to maintain certain reserves of vault cash or deposits with the Federal Reserve Bank. The amount of this reserve requirement, included in cash and due from banks, was approximately $313,000 and $211,000 as of December 31, 2017 and 2016, respectively.

## 3. Securities

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

| 2017 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| **Securities Available-for-Sale** | | | | |
| U.S. Treasury securities | $ 1,977,000 | $ - | $ (6,000) | $ 1,971,000 |
| State and municipal | 9,898,000 | 140,000 | (28,000) | 10,010,000 |
| Corporate bonds | 2,012,000 | - | (46,000) | 1,966,000 |
| Mortgage-backed and CMO's | 73,470,000 | 224,000 | (1,236,000) | 72,458,000 |
| Total debt securities | 87,357,000 | 364,000 | (1,316,000) | 86,405,000 |
| Marketable equity securities | 500,000 | - | (33,000) | 467,000 |
| Total securities available-for-sale | $ 87,857,000 | $ 364,000 | $ (1,349,000) | $ 86,872,000 |
| **Securities Held-to-Maturity** | | | | |
| Mortgage-backed and CMO's | $ 9,000 | $ - | $ - | $ 9,000 |
| Total securities held-to-maturity | $ 9,000 | $ - | $ - | $ 9,000 |

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

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous loss position at December 31, 2017:

| | Less than 12 months | | 12 months or longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Corporate bonds | $ - | $ - | $ 454,000 | $ (46,000) | $ 454,000 | $ (46,000) |
| Mortgage-backed and CMO's | 26,810,000 | (235,000) | 38,840,000 | (1,001,000) | 65,650,000 | (1,236,000) |
| U.S. Treasury securities | 1,971,000 | (6,000) | - | - | 1,971,000 | (6,000) |
| State and municipal | 2,113,000 | (18,000) | 956,000 | (10,000) | 3,069,000 | (28,000) |
| Marketable equity securities | - | - | 467,000 | (33,000) | 467,000 | (33,000) |
| Total temporarily impaired securities | $ 30,894,000 | $ (259,000) | $ 40,717,000 | $ (1,090,000) | $ 71,611,000 | $ (1,349,000) |

At December 31, 2017, unrealized losses within the marketable equity securities category relate to one individual security which had a continuous loss for more than one year. Unrealized losses within the mortgage backed and CMO's category relate to sixty-eight individual securities of which forty-three had continuous losses for more than one year. Unrealized losses within the state and municipal bonds category relate to seven individual securities of which two had continuous losses for more than one year. Unrealized losses within the corporate bond category relate to one bond which had a continuous loss position for more than one year. The primary cause for unrealized losses within the debt securities is the impact movements in interest rates have had in comparison to the underlying yields on these securities.

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

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

## 3. Securities (cont.)

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

Management evaluates investments for other-than-temporary impairment (OTTI) based on the type of investment and the period of time the investment has been in an unrealized loss position. At December 31, 2017 and 2016, management has determined that the current unrealized losses on these securities are consistent with changes in the overall bond and equity markets caused by an increase in market yields and spread levels and the securities are not other-than-temporarily impaired. The exception to this is a mortgage-backed security at Banc of America Funding Corporation (BAFC). Management performed an internal analysis on the market value of its investment at BAFC as of December 31, 2017 and 2016, and recognized OTTI write-downs of this security of $5,000 and $4,000 for the years ended December 31, 2017 and 2016, respectively.

At December 31, 2017 and 2016, securities with a fair value of $33,261,000 and $28,604,000, respectively, were pledged to secure certain borrowings and municipal deposits and repurchase agreements as required or permitted by law.

The amortized cost and fair value of debt securities by contractual maturity at December 31, 2017 follow:

| | Available-for-Sale | | Held-to-Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Within 1 year | $ 55,000 | $ 56,000 | $ - | $ - |
| Over 1 year through 5 years | 25,451,000 | 25,172,000 | 3,000 | 3,000 |
| Over 5 years through 10 years | 22,726,000 | 22,537,000 | 6,000 | 6,000 |
| Over 10 years | 39,125,000 | 38,640,000 | - | - |
| | $ 87,357,000 | $ 86,405,000 | $ 9,000 | $ 9,000 |

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

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

## 4. Loans

A summary of the loan balances are as follows:

| | 2017 | 2016 |
|---|---|---|
| Mortgage loans on real estate | | |
| Residential 1-4 family | $ 141,429,000 | $ 140,407,000 |
| Commercial | 331,373,000 | 296,737,000 |
| | 472,802,000 | 437,144,000 |
| Commercial loans | 164,431,000 | 161,017,000 |
| Municipal loans | 10,184,000 | 6,986,000 |
| Consumer installment loans | 13,155,000 | 17,146,000 |
| Business credit cards | 387,000 | 310,000 |
| Subtotal | 660,959,000 | 622,603,000 |
| Less: Allowance for loan losses | 6,048,000 | 6,032,000 |
| Add: Net deferred loan costs | 677,000 | 676,000 |
| Loans, net | $ 655,588,000 | $ 617,247,000 |

The following tables present the allowance for loan losses and select loan information for the years ended December 31, 2017 and 2016:

| | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | 2017 Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses | | | | | | |
| Beginning balance | $ 2,064,000 | $ 3,511,000 | $ 211,000 | $ 95,000 | $151,000 | $ 6,032,000 |
| Provision for (reduction of) loan losses | 657,000 | 449,000 | 145,000 | (26,000) | - | 1,225,0000 |
| Loans charged off | (276,000) | (1,003,000) | (158,000) | (28,000) | - | (1,465,000) |
| Recoveries of loans previously charged off | 57,000 | 143,000 | 23,000 | 33,000 | - | 256,000 |
| Ending balance | $ 2,502,000 | $ 3,100,000 | $ 221,000 | $ 74,000 | $151,000 | $ 6,048,000 |
| Individually evaluated for impairment | $ 430,000 | $ 218,000 | $ 22,000 | $ 10,000 | $ - | $ 680,000 |
| Collectively evaluated for impairment | $ 2,072,000 | $ 2,882,000 | $ 199,000 | $ 64,000 | $151,000 | $ 5,368,000 |
| Loans | | | | | | |
| Ending balance | $175,002,000 | $ 331,373,000 | $141,429,000 | $13,155,000 | | $660,959,000 |
| Individually evaluated for impairment | $ 2,635,000 | $ 3,018,000 | $ 882,000 | $ 105,000 | | $ 6,640,000 |
| Collectively evaluated for impairment | $172,367,000 | $ 328,355,000 | $140,547,000 | $13,050,000 | | $654,319,000 |

| | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | 2016 Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses | | | | | | |
| Beginning balance | $ 1,924,000 | $ 2,737,000 | $ 278,000 | $ 62,000 | $329,000 | $ 5,330,000 |
| Provision for (reduction of) loan losses | 556,000 | 818,000 | 34,000 | 86,000 | (178,000) | 1,316,000 |
| Loans charged off | (481,000) | (254,000) | (120,000) | (59,000) | - | (914,000) |
| Recoveries of loans previously charged off | 65,000 | 210,000 | 19,000 | 6,000 | - | 300,000 |
| Ending balance | $ 2,064,000 | $ 3,511,000 | $ 211,000 | $ 95,000 | $151,000 | $ 6,032,000 |
| Individually evaluated for impairment | $ 42,000 | $ 332,000 | $ 30,000 | $ - | $ - | $ 404,000 |
| Collectively evaluated for impairment | $ 2,022,000 | $ 3,179,000 | $ 181,000 | $ 95,000 | $151,000 | $ 5,628,000 |
| Loans | | | | | | |
| Ending balance | $168,313,000 | $ 296,737,000 | $140,407,000 | $17,146,000 | | $622,603,000 |
| Individually evaluated for impairment | $ 2,278,000 | $ 5,632,000 | $ 1,003,000 | $ 69,000 | | $ 8,982,000 |
| Collectively evaluated for impairment | $166,035,000 | $291,105,000 | $139,404,000 | $17,077,000 | | $613,621,000 |

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

### Commercial: Commercial and Commercial Real Estate

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

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

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

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

### 4. Loans (cont.)

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

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

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

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

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

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

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

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

The following tables summarize credit risk indicators by portfolio as of December 31, 2017 and 2016:

**Commercial Credit Risk Exposure**
**Credit Risk Profile by Internally Assigned Grade**

| 2017 | Commercial | Commercial Real Estate |
|---|---|---|
| Pass | $ 164,817,000 | $ 317,755,000 |
| Special mention | 4,009,000 | 10,628,000 |
| Substandard | 6,176,000 | 2,990,000 |
| Doubtful | - | - |
| Loss | - | - |
| 2017 Total | $ 175,002,000 | $ 331,373,000 |
| **2016** | | |
| Pass | $ 158,700,000 | $ 279,892,000 |
| Special mention | 4,808,000 | 7,491,000 |
| Substandard | 4,805,000 | 9,354,000 |
| Doubtful | - | - |
| Loss | - | - |
| 2016 Total | $ 168,313,000 | $ 296,737,000 |

**Consumer Credit Exposure**
**Credit Risk Profile by Internally Assigned Grade**

| 2017 | Residential Real Estate | Consumer-Installment | Consumer-Indirect Installment |
|---|---|---|---|
| Pass | $ 140,454,000 | $ 4,981,000 | $ 8,138,000 |
| Substandard | 975,000 | 29,000 | 7,000 |
| 2017 Total | $ 141,429,000 | $ 5,010,000 | $ 8,145,000 |
| **2016** | | | |
| Pass | $ 139,121,000 | $ 4,179,000 | $ 12,932,000 |
| Substandard | 1,286,000 | 35,000 | - |
| 2016 Total | $ 140,407,000 | $ 4,214,000 | $ 12,932,000 |

The following presents an aging analysis of past due loans as of December 31, 2017 and 2016:

| 2017 | 30-59 Days Past Due | 60-90 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Loans on Nonaccrual | Recorded Investment Loans > 90 Days & Accruing |
|---|---|---|---|---|---|---|---|---|
| Commercial | $ 1,795,000 | $ 86,000 | $ 2,297,000 | $ 4,178,000 | $ 170,824,000 | $ 175,002,000 | $ 2,556,000 | $ - |
| Commercial real estate | 555,000 | 182,000 | 415,000 | 1,152,000 | 330,221,000 | 331,373,000 | 1,119,000 | 356,000 |
| Residential real estate | 715,000 | 206,000 | 61,000 | 982,000 | 140,447,000 | 141,429,000 | 1,109,000 | 54,000 |
| Consumer – installment | 14,000 | - | - | 14,000 | 4,996,000 | 5,010,000 | 29,000 | - |
| Consumer – indirect installment | 153,000 | 62,000 | 1,000 | 216,000 | 7,929,000 | 8,145,000 | 44,000 | 1,000 |
| 2017 Total | $ 3,232,000 | $ 536,000 | $ 2,774,000 | $ 6,542,000 | $ 654,417,000 | $ 660,959,000 | $ 4,857,000 | $ 411,000 |
| **2016** | | | | | | | | |
| Commercial | $ 1,556,000 | $ 49,000 | $ 113,000 | $ 1,718,000 | $ 166,595,000 | $ 168,313,000 | $ 2,244,000 | $ - |
| Commercial real estate | 943,000 | 6,716,000 | - | 7,659,000 | 289,078,000 | 296,737,000 | 7,609,000 | - |
| Residential real estate | 976,000 | 19,000 | 5,000 | 1,000,000 | 139,407,000 | 140,407,000 | 1,037,000 | 5,000 |
| Consumer – installment | - | - | - | - | 4,214,000 | 4,214,000 | 35,000 | - |
| Consumer – indirect installment | 214,000 | 24,000 | - | 238,000 | 12,694,000 | 12,932,000 | - | - |
| 2016 Total | $ 3,689,000 | $ 6,808,000 | $ 118,000 | $10,615,000 | $ 611,988,000 | $ 622,603,000 | $ 10,925,000 | $ 5,000 |

**December 31, 2017 and 2016**

### 4. Loans (cont.)

The Bank takes a conservative approach in credit risk management and remains focused on community lending and reinvesting, working closely with borrowers experiencing credit problems to assist in loan repayment or term modifications. Troubled debt restructured loans (TDRs) consist of loans where the Bank, for economic or legal reasons related to the borrower's financial difficulties, granted a concession to the borrower that it would not otherwise consider. TDRs involve term modifications or a reduction of either interest or principal that the Bank would not normally make for other borrowers with similar risk characteristics. Once such an obligation has been restructured, it will continue to remain in restructured status until paid in full. Current balances of loan modifications qualifying as TDRs during the years ended December 31, 2017 and 2016 were $303,000 and $2,868,000, respectively. Loans restructured due to credit difficulties that are now performing were $2,573,000 and $2,980,000 at December 31, 2017 and 2016, respectively.

At December 31, 2017 and 2016, the allowance related to TDRs was $243,000 and $364,000, respectively. The specific reserve component was determined by using the fair value of the underlying collateral, which was obtained through independent appraisals and internal evaluations, or by discounting the total expected future cash flows from the borrower. There were no commitments to lend additional funds to borrowers with loans classified as TDRs at December 31, 2017 and 2016.

In 2017, there were no loans that did not perform according to the TDR terms and were subsequently charged off or transferred to OREO. In 2016, four commercial loans and one residential real estate loan did not perform according to the TDR terms and were subsequently charged off or transferred to OREO in the combined amount of $220,000.

The following is a summary of TDRs (accruing and non-accruing) by portfolio segment modified during the years ended December 31, 2017 and 2016:

| 2017 | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Current Balance |
|---|---|---|---|---|
| Commercial | 4 | $ 137,000 | $ 137,000 | $ 137,000 |
| Commercial real estate | 2 | 242,000 | 170,000 | 166,000 |
| 2017 Total | 6 | $ 379,000 | $ 307,000 | $ 303,000 |
| **2016** | | | | |
| Commercial | 18 | $ 1,897,000 | $ 1,425,000 | $ 1,764,000 |
| Commercial real estate | 3 | 1,079,000 | 1,079,000 | 1,069,000 |
| Consumer | 1 | 40,000 | 40,000 | 35,000 |
| 2016 Total | 22 | $ 3,016,000 | $ 2,544,000 | $ 2,868,000 |

The following is a summary of TDRs (accruing and non-accruing) by portfolio segment as of December 31, 2017 and 2016:

| 2017 | Number of Contracts | Current Balance | Related Allowance |
|---|---|---|---|
| Commercial | 24 | $ 802,000 | $ 3,000 |
| Commercial real estate | 32 | 2,867,000 | 218,000 |
| Residential real estate | 4 | 648,000 | 22,000 |
| Consumer | 1 | 29,000 | - |
| 2017 Total | 61 | $ 4,346,000 | $ 243,000 |
| **2016** | | | |
| Commercial | 29 | $ 2,006,000 | $ 2,000 |
| Commercial real estate | 33 | 4,731,000 | 332,000 |
| Residential real estate | 5 | 694,000 | 30,000 |
| Consumer | 1 | 35,000 | - |
| 2016 Total | 68 | $ 7,466,000 | $ 364,000 |

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

The following table presents a summary of information pertaining to impaired loans by loan category as of December 31, 2017 and 2016:

| 2017 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Interest Income Recognized |
|---|---|---|---|---|
| With no related allowance recorded: | | | | |
| Commercial | $ 1,150,000 | $ 1,150,000 | $ - | $ 19,000 |
| Commercial real estate | 1,622,000 | 1,622,000 | - | 80,000 |
| Residential real estate | 709,000 | 709,000 | - | 3,000 |
| Consumer | 90,000 | 90,000 | - | 3,000 |
| With an allowance recorded: | | | | |
| Commercial | $ 1,485,000 | $ 1,485,000 | $ 430,000 | $ 68,000 |
| Commercial real estate | 1,396,000 | 1,396,000 | 218,000 | 66,000 |
| Residential real estate | 173,000 | 173,000 | 22,000 | 1,000 |
| Consumer | 15,000 | 15,000 | 10,000 | 2,000 |
| 2017 Total: | | | | |
| Commercial | $ 2,635,000 | $ 2,635,000 | $ 430,000 | $ 87,000 |
| Commercial real estate | 3,018,000 | 3,018,000 | 218,000 | 146,000 |
| Residential real estate | 882,000 | 882,000 | 22,000 | 4,000 |
| Consumer | 105,000 | 105,000 | 10,000 | 5,000 |

| 2016 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Interest Income Recognized |
|---|---|---|---|---|
| With no related allowance recorded: | | | | |
| Commercial | $ 1,970,000 | $ 1,970,000 | $ - | $ 35,000 |
| Commercial real estate | 2,243,000 | 2,243,000 | - | 34,000 |
| Residential real estate | 822,000 | 822,000 | - | 5,000 |
| Consumer | 69,000 | 69,000 | - | 3,000 |
| With an allowance recorded: | | | | |
| Commercial | $ 308,000 | $ 308,000 | $ 42,000 | $ 19,000 |
| Commercial real estate | 3,389,000 | 3,389,000 | 332,000 | 170,000 |
| Residential real estate | 181,000 | 181,000 | 30,000 | 11,000 |
| Consumer | - | - | - | - |
| 2016 Total: | | | | |
| Commercial | $ 2,278,000 | $ 2,278,000 | $ 42,000 | $ 54,000 |
| Commercial real estate | 5,632,000 | 5,632,000 | 332,000 | 204,000 |
| Residential real estate | 1,003,000 | 1,003,000 | 30,000 | 16,000 |
| Consumer | 69,000 | 69,000 | - | 3,000 |

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

| | 2017 | 2016 |
|---|---|---|
| Impaired loans without a valuation allowance | $ 3,571,000 | $ 5,104,000 |
| Impaired loans with a valuation allowance | 3,069,000 | 3,878,000 |
| Total impaired loans | $ 6,640,000 | $ 8,982,000 |
| Valuation allowance related to impaired loans | $ 680,000 | $ 404,000 |
| Average investment in impaired loans | $ 9,311,000 | $ 8,677,000 |

December 31, 2017 and 2016, there were five and six mortgage loans, respectively, collateralized by residential real estate in the process of foreclosure with a total balance of $227,000 and $331,000, respectively.

### 5. Bank Premises and Equipment

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

| | 2017 | 2016 |
|---|---|---|
| Land | $ 2,740,000 | $ 2,755,000 |
| Buildings | 11,530,000 | 11,901,000 |
| Equipment | 12,837,000 | 12,477,000 |
| Leasehold improvements | 1,112,000 | 1,112,000 |
| Construction in progress | - | 170,000 |
| | 28,219,000 | 28,415,000 |
| Accumulated depreciation | (17,170,000) | (16,253,000) |
| | $ 11,049,000 | $ 12,162,000 |

## 6. Investments in Limited Partnerships

Through June 2016, the Company held investments in limited partnerships with related New Market Tax Credits (NMTC). These investments were carried at cost and amortized on the effective yield method. Amortization of the investments in the limited partnerships for the year ended December 31, 2016 totaled $69,000, and is recognized as a component of income tax expense in the consolidated statements of income.

## 7. Deposits

At December 31, 2017, the scheduled maturities of time deposits are as follows:

| | |
|---|---|
| 2018 | $ 130,542,000 |
| 2019 | 39,338,000 |
| 2020 | 8,709,000 |
| 2021 | 5,717,000 |
| 2022 and thereafter | 9,210,000 |
| | $ 193,516,000 |

## 8. Advances from Federal Home Loan Bank

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

Fixed-rate advances of $55,167,000 and $20,178,000 at December 31, 2017 and 2016, respectively, mature through August 2023. At December 31, 2017 and 2016, the interest rates on fixed rate advances ranged from 0.00 to 2.19 percent. At December 31, 2017 and 2016, the weighted-average interest rates on fixed-rate advances were 1.59 percent and 0.69 percent, respectively.

The floating rate advance of $10,700,000 at December 31, 2017 matures in January 2018. At December 31, 2017, the interest rate on the floating rate advance was 1.59 percent. The floating rate advance of $1,000,000 at December 31, 2016 matured in January 2017. At December 31, 2016, the interest rate on the floating rate advance was 0.80 percent.

At December 31, 2017 and 2016, the Company also had $1,000,000 available under a long-term line of credit with the FHLB.

The contractual maturities of advances at December 31, 2017 are as follows:

| | |
|---|---|
| 2018 | $ 38,700,000 |
| 2019 | 8,000,000 |
| 2020 | 15,000,000 |
| 2021 | 4,000,000 |
| 2023 | 167,000 |

## 9. Other Borrowed Funds

Other borrowed funds of $118,000 and $889,000 at December 31, 2017 and 2016, respectively, consist of securities sold under agreements to repurchase.

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date, except for the term repurchase agreements. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. At December 31, 2017 and 2016, securities with a fair value of $118,000 and $889,000, respectively, were pledged to secure other borrowed funds.

Information concerning securities sold under agreements to repurchase for the years ended December 31, 2017 and 2016 is summarized as follows:

| | 2017 | 2016 |
|---|---|---|
| Average balance during the year | $ 270,000 | $ 647,000 |
| Average interest rate during the year | 0.10% | 0.10% |
| Maximum month-end balance during the year | $ 769,000 | $ 889,000 |

At December 31, 2017, the Company also had $8,500,000 available under lines of credit with other banks which were in addition to the line of credit disclosed in Note 8. There were no advances outstanding at December 31, 2017.

## 10. Capital Trust Securities

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

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

## 11. Income Taxes

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

| | 2017 | 2016 |
|---|---|---|
| Current tax provision | | |
| Federal | $ 2,504,000 | $ 1,230,000 |
| State | 113,000 | 120,000 |
| | 2,617,000 | 1,350,000 |
| Deferred federal tax provision | 154,000 | 514,000 |
| | $ 2,771,000 | $ 1,864,000 |

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

| | 2017 | 2016 |
|---|---|---|
| Computed tax expense | $ 2,384,000 | $ 2,230,000 |
| Increase (reduction) in income taxes resulting from: | | |
| Tax exempt interest | (166,000) | (121,000) |
| State taxes, net of federal benefit | 113,000 | 79,000 |
| Income from life insurance | (113,000) | (105,000) |
| Preferred stock dividends | (5,000) | (5,000) |
| Tax credits, net of investment amortization | - | (66,000) |
| Change in federal tax rate | 271,000 | - |
| Other | 287,000 | (148,000) |
| | $ 2,771,000 | $ 1,864,000 |

Deferred tax assets and liabilities are recognized at the expected future tax rate. On December 22, 2017, the Federal tax rate decreased from 34% to 21% effective January 1, 2018. Accordingly, deferred tax assets and liabilities were revalued at December 31, 2017 to reflect the 21% tax rate.

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

## 11. Income Taxes (cont.)

| | 2017 | 2016 |
|---|---|---|
| Deferred tax assets | | |
| Other-than-temporary impairment of investment securities | $ 46,000 | $ 73,000 |
| Allowance for loan losses | 1,270,000 | 2,051,000 |
| Employee benefit plans | 511,000 | 799,000 |
| Net unrealized loss on derivative instruments | - | 164,000 |
| Net unrealized loss on securities available-for-sale | 207,000 | 441,000 |
| Other | 51,000 | 96,000 |
| | 2,085,000 | 3,624,000 |
| Deferred tax liabilities | | |
| Depreciation | 418,000 | 808,000 |
| Amortization of goodwill | 1,038,000 | 1,629,000 |
| Amortization of interest rate cap premium | 79,000 | 192,000 |
| Prepaid expenses | 96,000 | 124,000 |
| Net unrealized gain on derivative instruments | 5,000 | - |
| Other | 13,000 | 1,000 |
| | 1,649,000 | 2,754,000 |
| Net deferred tax asset | $ 436,000 | $ 870,000 |

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

## 12. Earnings Per Share

The following sets forth the computation of basic and diluted earnings per common share for 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| Net income available to common shareholders, as reported | $ 3,478,000 | $ 3,939,000 |
| Weighted-average common shares outstanding | 3,373,220 | 3,399,826 |
| Effect of unvested restricted stock grants | - | - |
| Diluted weighted-average common shares | 3,373,220 | 3,399,826 |
| Basic earnings per common share | $ 1.03 | $ 1.16 |
| Diluted earnings per common share | $ 1.03 | $ 1.16 |

## 13. Financial Instruments with Off-Balance-Sheet Risk

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

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

At December 31, 2017 and 2016, the contractual amounts of the Company's financial instruments were as follows:

| | Contract Amount | |
|---|---|---|
| | 2017 | 2016 |
| Lending-related instruments: | | |
| Home equity lines-of-credit | $ 21,173,000 | $ 19,580,000 |
| Other lines-of-credit | 58,632,000 | 57,484,000 |
| Credit card arrangements | 2,488,000 | 2,265,000 |
| Letters-of-credit | 3,365,000 | 2,505,000 |
| Derivative financial instruments: | | |
| Notional amounts of interest rate swaps | 120,572,000 | 96,240,000 |
| Notional amounts of interest rate caps | 25,000,000 | 28,000,000 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for lines-of-credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements.

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

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

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

## 14. Significant Group Concentrations of Credit Risk

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

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

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

## 15. Legal Contingencies

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

## 16. Minimum Regulatory Capital Requirements

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

Effective January 1, 2015, the Bank implemented the Basel III regulatory framework. These new rules and framework revised minimum capital requirements and adjusted prompt corrective action thresholds. Under the Basel III regulatory framework, the quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital and common equity Tier 1 (as defined in the regulations) to risk-weighted assets (as defined) and of Tier 1 capital (as defined) to average assets (as defined). Effective in 2015, the Company is considered a Small Bank Holding Company and therefore not subject to the Basel III capital rules. Regulatory capital requirements limit a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% above its minimum risk-based capital requirements. The capital conservation buffer requirement is being phased in from January 1, 2016 through January 1, 2019, when the full capital conservation buffer requirement

## 16. Minimum Regulatory Capital Requirements (cont.)

will be effective. As of December 31, 2017, the Bank had a capital conservation buffer of 4.65% of risk-weighted assets, which was in excess of the phased-in regulatory requirement of 1.25%. As of December 31, 2016, the Bank had a capital conservation buffer of 5.02% of risk-weighted assets, which was in excess of the phased-in regulatory requirement of 0.625%. Management believes, as of December 31, 2017 and 2016, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2017, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31, 2017 and 2016 are also presented in the table.

| As of December 31, 2017 | Actual | | Minimum Capital Requirement | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital to Risk-Weighted Assets Bank | $ 76,457,000 | 12.7% | $ 48,371,000 | 8.0% | $ 60,464,000 | 10.0% |
| Tier 1 Capital to Risk-Weighted Assets Bank | 70,376,000 | 11.6 | 36,278,000 | 6.0 | 48,371,000 | 8.0 |
| Common Equity Tier 1 Capital to Risk-Weighted Assets Bank | 70,376,000 | 11.6 | 27,209,000 | 4.5 | 39,301,000 | 6.5 |
| Tier 1 Capital to Average Assets Bank | 70,376,000 | 8.9 | 31,669,000 | 4.0 | 39,586,000 | 5.0 |
| **As of December 31, 2016** | | | | | | |
| Total Capital to Risk-Weighted Assets Bank | $ 74,235,000 | 13.0% | $ 45,627,000 | 8.0% | $ 57,033,000 | 10.0% |
| Tier 1 Capital to Risk-Weighted Assets Bank | 68,169,000 | 12.0 | 34,220,000 | 6.0 | 45,627,000 | 8.0 |
| Common Equity Tier 1 Capital to Risk-Weighted Assets Bank | 68,169,000 | 12.0 | 25,665,000 | 4.5 | 37,072,000 | 6.5 |
| Tier 1 Capital to Average Assets Bank | 68,169,000 | 9.2 | 29,791,000 | 4.0 | 37,239,000 | 5.0 |

## 17. Employee Benefit Plans

The Company has a safe harbor 401(k) plan whereby substantially all employees participate in the plan. Employees may contribute a portion of their compensation subject to certain limits based on federal tax laws. The Company makes safe harbor matching contributions equal to 100% of the first 3% of an employee's compensation plus 50% of the next 2% of an employee's compensation in addition to a discretionary contribution. For the years ended December 31, 2017 and 2016, expense attributable to the plan amounted to $330,000 and $348,000, respectively.

The Company has established a nonqualified supplemental executive retirement plan for the benefit of key employees. The amount of each benefit is guaranteed contingent upon employee vesting schedules. The present value of these benefits, being expensed over the employment service period, amounted to $309,000 and $281,000 for 2017 and 2016, respectively. Life insurance policies were acquired for the purpose of serving as the primary funding source. The cash value of these policies was $11,751,000 and $11,421,000 at December 31, 2017 and 2016, respectively, and is included in other assets.

For 2017 and 2016, in addition to a retainer fee of $13,000 for regular directors, $15,000 for the vice-chairman, and $16,000 for the chairman, outside directors of the Bank received $675, for each Board meeting attended, and for each subcommittee meeting attended.

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

## 18. Restricted Stock Plan

The Company established a restricted stock plan during 2010 with 100,000 shares currently authorized by the Board of Directors for the compensation committee of the Board to administer. The compensation committee did not grant restricted stock during 2017 or 2016. A total of 11,897 shares have been issued under the restricted stock plan since inception, all of which are vested.

## 19. Other Noninterest Expenses

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

| | 2017 | 2016 |
|---|---|---|
| Printing, postage and supplies | $ 476,000 | $ 506,000 |
| Professional fees | 439,000 | 383,000 |

## 20. Related Party Transactions

In the ordinary course of business, the Company has granted loans to principal officers and directors and their affiliates amounting to $17,678,000 and $14,568,000 at December 31, 2017 and 2016, respectively. Deposits from related parties held by the Company at December 31, 2017 and 2016 amounted to $6,444,000 and $6,138,000, respectively.

## 21. Employee Stock Ownership Plan

All Bank employees meeting certain age and service requirements are eligible to participate in the ESOP.

The Bank's ESOP purchased shares of Katahdin Bankshares Corp. common stock that include outstanding debt as follows:

| Date | Shares | Net Price Per Share | Original Debt | Principal Balance Dec. 31, 2017 |
|---|---|---|---|---|
| October 2016 | 25,000 | $ 11.25 | $ 287,000 | $ 186,000 |

The October 2016 loan is from Katahdin Bankshares Corp. and is repayable annually with an interest rate of 2.55% for the term of 4 years.

| Date | Shares | Net Price Per Share | Original Debt | Principal Balance Dec. 31, 2017 |
|---|---|---|---|---|
| September 2017 | 27,000 | $ 13.99 | $ 371,000 | $ 371,000 |

The September 2017 loan is from Katahdin Bankshares Corp. and is repayable annually with an interest rate of 3.30% for a term of 6 years and 3 months. The loan is interest only through 2020.

The loans are secured by the shares purchased by the ESOP. Participants' benefits become fully vested after five years of service. The Bank's contributions are the primary source of funds for the ESOP's repayment of the loans. Principal and interest payments for the years ended December 31, 2017 and 2016 totaled $97,000 and $15,000, respectively. ESOP expense was $87,000 and $16,000 for the years ended December 31, 2017 and 2016, respectively.

As of December 31, 2017, the remaining principal balance of the loans are scheduled to be paid as follows:

| | |
|---|---|
| 2018 | $ 89,000 |
| 2019 | 92,000 |
| 2020 | 93,000 |
| 2021 | 92,000 |
| 2022 | 95,000 |
| 2023 | 96,000 |
| | $ 557,000 |

**December 31, 2017 and 2016**

## 21. Employee Stock Ownership Plan (cont.)

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

| | 2017 | 2016 |
|---|---|---|
| Allocated | 9,431 | 1,306 |
| Unallocated | 43,069 | 24,194 |
| | 52,500 | 25,500 |

The fair value of the unallocated shares as of December 31, 2017 and 2016 was approximately $683,000 and $314,000, respectively.

## 22. Fair Value

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

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

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

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

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

### Assets and Liabilities Recorded at Fair Value on a Recurring Basis

*Securities available-for-sale:* Fair values for securities available-for-sale are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The fair values of securities available-for-sale are classified as Level 2, except for the fair value of marketable equity securities which are classified as Level 1 using quoted market prices.

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

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

| | | Fair Value Measurements at December 31, 2017 and 2016, Using | | |
|---|---|---|---|---|
| December 31, 2017 | Total | Quoted Prices In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | | |
| Securities available-for-sale | | | | |
| U.S. Treasury securities | $ 1,971,000 | $ - | $ 1,971,000 | $ - |
| State and municipal | 10,010,000 | - | 10,010,000 | - |
| Corporate bonds | 1,966,000 | - | 1,966,000 | - |
| Mortgage-backed and CMO's | 72,458,000 | - | 72,458,000 | - |
| Total debt securities | 86,405,000 | - | 86,405,000 | - |
| Marketable equity securities | 467,000 | 467,000 | - | - |
| Total securities available-for-sale | 86,872,000 | 467,000 | 86,405,000 | - |
| Derivative instruments | 2,314,000 | - | 2,314,000 | - |
| Total assets | $ 89,186,000 | $ 467,000 | $88,719,000 | $ - |
| Liabilities | | | | |
| Derivative instruments | $ 1,355,000 | $ - | $ 1,355,000 | $ - |

| December 31, 2016 | Total | Quoted Prices In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Assets | | | | |
| Securities available-for-sale | | | | |
| U.S. Treasury securities | $ 1,981,000 | $ - | $ 1,981,000 | $ - |
| State and municipal | 9,478,000 | - | 9,478,000 | - |
| Corporate bonds | 921,000 | - | 921,000 | - |
| Mortgage-backed and CMO's | 74,442,000 | - | 74,442,000 | - |
| Total debt securities | 86,822,000 | - | 86,822,000 | - |
| Marketable equity securities | 449,000 | 449,000 | - | - |
| Total securities available-for-sale | 87,271,000 | 449,000 | 86,822,000 | - |
| Derivative instruments | 2,533,000 | - | 2,533,000 | - |
| Total assets | $ 89,804,000 | $ 449,000 | $89,355,000 | $ - |
| Liabilities | | | | |
| Derivative instruments | $ 1,463,000 | $ - | $ 1,463,000 | $ - |

### Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

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

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

| | | Fair Value Measurements at December 31, 2017 and 2016, Using | | |
|---|---|---|---|---|
| December 31, 2017 | Total | Quoted Prices In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets | | | | |
| Impaired loans (market approach) | $ 2,389,000 | $ - | $ 2,389,000 | $ - |
| Other real estate and property owned (market approach) | 384,000 | - | 384,000 | - |
| December 31, 2016 | | | | |
| Assets | | | | |
| Impaired loans (market approach) | $ 3,474,000 | $ - | $ 3,474,000 | $ - |
| Other real estate and property owned (market approach) | 454,000 | - | 454,000 | - |

Certain impaired loans were written down to their value of $2,389,000 and $3,474,000 at December 31, 2017 and 2016, respectively, resulting in an impairment charge through the allowance for loan losses.

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

## 22. Fair Value (cont.)

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

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

*Securities:* Fair values for securities, excluding FHLB stock, are determined by obtaining quoted prices on nationally recognized securities exchanges or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities. The carrying value of FHLB stock approximates fair value based on the redemption provisions of the FHLB.

*Loans receivable:* For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The fair value of impaired loans is primarily based upon appraisals of the collateral by third-party appraisers and brokers' opinions by third-party brokers. The appraisals and opinions are based upon comparable prices for similar assets in active markets for residential real estate loans, and less active markets for commercial loans.

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

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

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

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

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

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

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

| | Fair Value Measurement at December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Quoted Prices In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets | | | | | |
| Cash and due from banks | $ 7,895,000 | $ 7,895,000 | $ 7,895,000 | $ - | $ - |
| Interest bearing deposits in banks | 6,089,000 | 6,089,000 | 6,089,000 | - | - |
| Securities available-for-sale | 86,872,000 | 86,872,000 | 467,000 | 86,405,000 | - |
| Securities held-to-maturity | 9,000 | 9,000 | - | 9,000 | - |
| FHLB stock | 3,564,000 | 3,564,000 | - | 3,564,000 | - |
| Loans receivable, net: | | | | | |
| Commercial | 172,639,000 | 172,254,000 | - | 1,055,000 | 171,199,000 |
| Commercial real estate | 328,537,000 | 319,463,000 | - | 1,178,000 | 318,285,000 |
| Residential real estate | 141,321,000 | 139,245,000 | - | 151,000 | 139,094,000 |
| Consumer | 13,091,000 | 13,175,000 | - | 5,000 | 13,170,000 |
| Loan receivable, net | 655,588,000 | 644,137,000 | - | 2,389,000 | 641,748,000 |
| Accrued interest receivable | 1,685,000 | 1,685,000 | - | 1,685,000 | - |
| Derivative instruments | 2,314,000 | 2,314,000 | - | 2,314,000 | - |
| Financial liabilities | | | | | |
| Deposits | 647,752,000 | 630,522,000 | - | 630,522,000 | - |
| Advances from FHLB | 65,867,000 | 65,590,000 | - | 65,590,000 | - |
| Other borrowed funds | 118,000 | 118,000 | - | 118,000 | - |
| Accrued interest payable | 254,000 | 254,000 | - | 254,000 | - |
| Junior subordinated debentures | 7,217,000 | 7,217,000 | - | 7,217,000 | - |
| Derivative instruments | 1,355,000 | 1,355,000 | - | 1,355,000 | - |

| | Fair Value Measurement at December 31, 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Quoted Prices In Active Markets For Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets | | | | | |
| Cash and due from banks | $ 6,450,000 | $ 6,450,000 | $ 6,450,000 | $ - | $ - |
| Interest bearing deposits in banks | 4,873,000 | 4,873,000 | 4,873,000 | - | - |
| Securities available-for-sale | 87,271,000 | 87,271,000 | 449,000 | 86,822,000 | - |
| Securities held-to-maturity | 12,000 | 12,000 | - | 12,000 | - |
| FHLB stock | 1,682,000 | 1,682,000 | - | 1,682,000 | - |
| Loans receivable, net: | | | | | |
| Commercial | 166,391,000 | 166,999,000 | - | 266,000 | 166,733,000 |
| Commercial real estate | 293,476,000 | 288,426,000 | - | 3,057,000 | 285,369,000 |
| Residential real estate | 140,314,000 | 139,340,000 | - | 151,000 | 139,189,000 |
| Consumer | 17,066,000 | 17,262,000 | - | - | 17,262,000 |
| Loan receivable, net | 617,247,000 | 612,027,000 | - | 3,474,000 | 608,553,000 |
| Accrued interest receivable | 1,618,000 | 1,618,000 | - | 1,618,000 | - |
| Derivative instruments | 2,533,000 | 2,533,000 | - | 2,533,000 | - |
| Financial liabilities | | | | | |
| Deposits | 652,969,000 | 638,800,000 | - | 638,800,000 | - |
| Advances from FHLB | 21,178,000 | 21,182,000 | - | 21,182,000 | - |
| Other borrowed funds | 889,000 | 889,000 | - | 889,000 | - |
| Accrued interest payable | 183,000 | 183,000 | - | 183,000 | - |
| Junior subordinated debentures | 7,217,000 | 7,217,000 | - | 7,217,000 | - |
| Derivative instruments | 1,463,000 | 1,463,000 | - | 1,463,000 | - |

## 23. Preferred Stock

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

On June 27, 2014, the Company issued 4,000 shares of Preferred Series D floating rate non-cumulative perpetual preferred stock at an issuance price of $2,500 per share. The net proceeds from the issuance totaled $9,603,000. The dividend will be set quarterly at a floating rate of 3 month LIBOR plus 4.25%, with a floor of 8.75%. Dividends on Preferred Series D are payable quarterly in arrears on January 15, April 15, July 15, and October 15 of each year.

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

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

## 24. Interest Rate Swaps and Caps

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

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**December 31, 2017 and 2016**

### 24. Interest Rate Swaps and Caps (cont.)

rating. At December 31, 2016, the Company had posted $100,000 of cash as collateral. As no contracts were in a net loss position at December 31, 2017, the Company did not have any cash posted as collateral at that date.

The following table presents the details of the interest rate swap agreements:

| Party | Notional Amount | Effective Date | Maturity Date | Variable Index Received | Fixed Rate Paid | Fair Value as of Dec. 31, 2017 | Fair Value as of Dec. 31, 2016 |
|---|---|---|---|---|---|---|---|
| Company | $ 4,000,000 | April 7, 2010 | April 7, 2017 | 3-Month USD LIBOR | 3.48% | $ - | $(27,000) |
| Bank | 15,000,000 | July 1, 2016 | June 30, 2020 | 1-Month USD LIBOR | 0.855 | 430,000 | 381,000 |

As these instruments qualify as highly effective cash flow hedges, changes in fair value are recorded in other comprehensive income (loss), net of tax.

The following presents the details of interest rate protection agreements (caps):

| Party | Notional Amount | Up Front Premiums Paid | Termination Date | Floating Rate Option | Strike Rate | Fair Value as of Dec. 31, 2017 | Fair Value as of Dec. 31, 2016 |
|---|---|---|---|---|---|---|---|
| Company | $ 3,000,000 | $ 270,000 | April 7, 2017 | 3-Month USD LIBOR | 3.48% | $ - | $ - |
| Bank | 25,000,000 | 1,998,000 | April 4, 2019 | 3-Month USD LIBOR | 0.23 | 529,000 | 716,000 |

The caps were acquired to limit the Company's exposure to interest rates. The up-front premiums are being amortizing based on the expense amortization schedules established at the inception of the hedges, with the corresponding adjustment to the income statement. At inception, the hedging relationships were expected to be 100% effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedges. As these instruments qualify as highly effective cash flow hedges, the change in fair value is recorded in other comprehensive income (loss), net of tax.

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

The following table presents summary information regarding the fair value of customer related interest rate swaps, which are included in other assets (liabilities) as of December 31:

| | 2017 Asset (Liability) | 2016 Asset (Liability) |
|---|---|---|
| Swaps receive fixed | $ 1,355,000 | $ 1,436,000 |
| Swaps pay fixed | (1,355,000) | (1,436,000) |
| Net customer related swaps | $ - | $ - |

The outstanding notional amounts of interest rate swaps entered into on behalf of customers at December 31 were as follows:

| | 2017 | 2016 |
|---|---|---|
| Swaps receive fixed | $ 52,786,000 | $ 38,620,000 |
| Swaps pay fixed | (52,786,000) | (38,620,000) |

### 25. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about the conditions that existed at the balance sheet date, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the balance sheet date, but arose after that date. Management has evaluated subsequent events occurring through February 14, 2018, the date the financial statements were available to be issued.

# SHAREHOLDER INFORMATION

### ANNUAL MEETING

The Annual Shareholders' Meeting will be held in the Katahdin Trust Company Room at The Center for Community Health Education at Houlton Regional Hospital, Houlton, Maine on Monday, May 7, 2018 at 10:30 a.m.

### SHAREHOLDER RELATIONS

Katahdin Bankshares Corp. and Katahdin Trust Company welcome shareholder and public interest in our services and activities. Questions or comments pertaining to this report and requests for other information should be directed to:

**Matthew M. Nightingale**
Executive Vice President, Treasurer & CFO
PO Box 450 | Patten, ME 04765
(207) 521-3200
m.nightingale@katahdintrust.com

### STOCK

Katahdin Bankshares Corp. stock is quoted on the OTC Markets quote board OTCQX under the symbol KTHN. Current stock information can be found at otcmarkets.com/stock/KTHN/quote.

BEST 50 OTCQX 2018

### TRANSFER AGENT

For shareholder inquiries regarding change of address or title, please contact:

Computershare Trust Company, N.A .
PO Box 30170 | College Station, TX 77842-3170
1-800-368-5948 (U.S. or Canada)
1-781-575-4223 (outside the U.S. or Canada)
computershare.com/investor

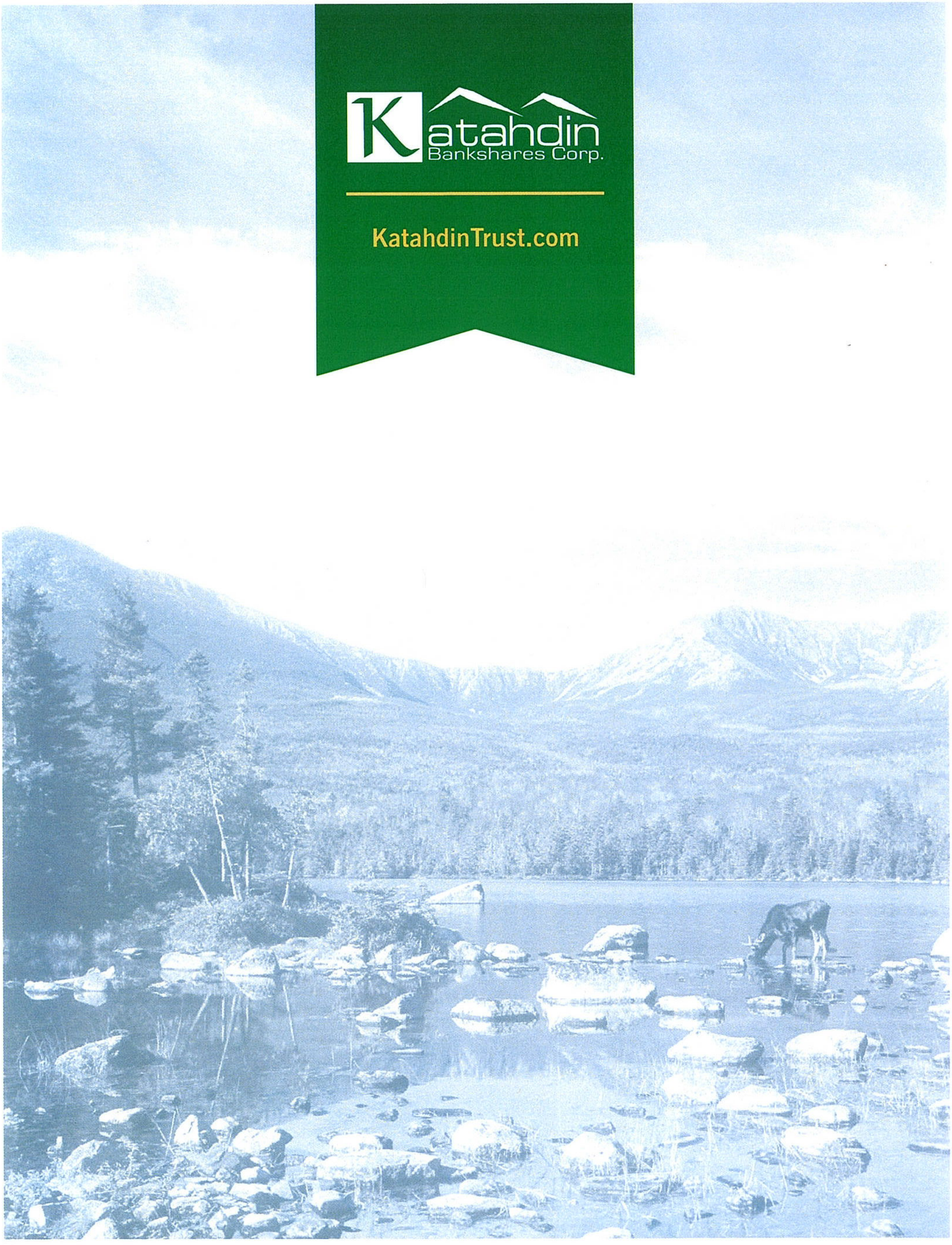
### DIRECT STOCK PURCHASE AND DIVIDEND REINVESTMENT PLAN

Katahdin's transfer agent, Computershare Trust Company, N.A. ("Computershare"), sponsors and administers the Computershare Investment Plan (CIP) for Katahdin Bankshares Corp. Common Stock. This plan offers direct stock purchase and dividend reinvestment options and is available to current Katahdin Bankshares Corp. shareholders as well as new investors. For more information, you may contact Computershare.

### BRANCH OFFICES

Ashland, Bangor, Caribou, Eagle Lake, Fort Fairfield, Fort Kent, Hampden, Houlton, Island Falls, Mars Hill, Oakfield, Patten, Presque Isle, Scarborough and Van Buren.

Learn more about Katahdin Trust on our website at KatahdinTrust.com and get the latest news and information by following us on Facebook, Twitter, LinkedIn, and Instagram.


Katahdin
Bankshares Corp.
KatahdinTrust.com

**Results:** A list of branches for your depository institution: KATAHDIN TRUST COMPANY (ID_RSSD: 327305).
This depository institution is held by KATAHDIN BANKSHARES CORPORATION (1140127) of PATTEN, ME.
The data are as of 12/31/2017. Data reflects information that was received and processed through 01/04/2018.

**Reconciliation and Verification Steps**

1. In the **Data Action** column of each branch row, enter one or more of the actions specified below
2. If required, enter the date in the **Effective Date** column

**Actions**

**OK:** If the branch information is correct, enter 'OK' in the **Data Action** column.
**Change:** If the branch information is incorrect or incomplete, revise the data, enter 'Change' in the **Data Action** column and the date when this information first became valid in the **Effective Date** column.
**Close:** If a branch listed was sold or closed, enter 'Close' in the **Data Action** column and the sale or closure date in the **Effective Date** column.
**Delete:** If a branch listed was never owned by this depository institution, enter 'Delete' in the **Data Action** column.
**Add:** If a reportable branch is missing, insert a row, add the branch data, and enter 'Add' in the **Data Action** column and the opening or acquisition date in the **Effective Date** column.

If printing this list, you may need to adjust your page setup in MS Excel. Try using landscape orientation, page scaling, and/or legal sized paper.

**Submission Procedure**

When you are finished, send a saved copy to your FRB contact. See the detailed instructions on this site for more information.
If you are e-mailing this to your FRB contact, put your institution name, city and state in the subject line of the e-mail.

Note:
To satisfy the **FR Y-10 reporting requirements**, you must also submit FR Y-10 Domestic Branch Schedules for each branch with a **Data Action** of Change, Close, Delete, or Add.
The FR Y-10 report may be submitted in a hardcopy format or via the FR Y-10 Online application - https://y10online.federalreserve.gov.

* FDIC UNINUM, Office Number, and ID_RSSD columns are for reference only. Verification of these values is not required.

| Data Action | Effective Date | Branch Service Type | Branch ID_RSSD* | Popular Name | Street Address | City | State | Zip Code | County | Country | FDIC UNINUM* | Office Number* | Head Office | Head Office ID_RSSD* | Comments |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| OK | | Full Service (Head Office) | 327305 | KATAHDIN TRUST COMPANY | 11 MAIN STREET | PATTEN | ME | 04765 | PENOBSCOT | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 114206 | ASHLAND BRANCH | 17 MAIN STREET | ASHLAND | ME | 04732 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 4181457 | BROADWAY BRANCH | 609 BROADWAY | BANGOR | ME | 04401 | PENOBSCOT | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 4420491 | SPRINGER DRIVE BRANCH | 52 SPRINGER DRIVE | BANGOR | ME | 04401 | PENOBSCOT | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 3775569 | CARIBOU BRANCH | 105 BENNETT DRIVE | CARIBOU | ME | 04736 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 150802 | EAGLE LAKE OFFICE | 3440 AROOSTOOK ROAD | EAGLE LAKE | ME | 04739 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 307307 | FORT FAIRFIELD OFFICE | 290 MAIN STREET | FORT FAIRFIELD | ME | 04742 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 4721031 | FORT KENT BRANCH | 79 WEST MAIN STREET | FORT KENT | ME | 04743 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 4396103 | HAMPDEN BRANCH | 57 WESTERN AVENUE | HAMPDEN | ME | 04444 | PENOBSCOT | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 1189313 | HOULTON BRANCH | 65 NORTH STREET | HOULTON | ME | 04730 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 139302 | ISLAND FALLS BRANCH | 1007 CRYSTAL ROAD | ISLAND FALLS | ME | 04747 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 2524304 | MARS HILL BRANCH | 28 MAIN STREET | MARS HILL | ME | 04758 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 290306 | OAKFIELD BRANCH | 200 OAKFIELD SMYRNA ROAD | OAKFIELD | ME | 04763 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 1850556 | PRESQUE ISLE BRANCH | 6 NORTH STREET | PRESQUE ISLE | ME | 04769 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 4556774 | SCARBOROUGH BRANCH | 144 US ROUTE 1 | SCARBOROUGH | ME | 04074 | CUMBERLAND | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |
| OK | | Full Service | 369109 | VAN BUREN BRANCH | 29 MAIN STREET | VAN BUREN | ME | 04785 | AROOSTOOK | UNITED STATES | Not Required | Not Required | KATAHDIN TRUST COMPANY | 327305 | |