

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.

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

03/28/2019

Date of Signature

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

- ☒ 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

C.I.

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.

Date of Report (top-tier holding company's fiscal year-end):

December 31, 2018

Month / Day / Year

549300PRPWDL1R15M21 N/A

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

Physical Location (if different from mailing address)

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City State Zip Code

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

City State Zip Code

Physical Location (if different from mailing address)

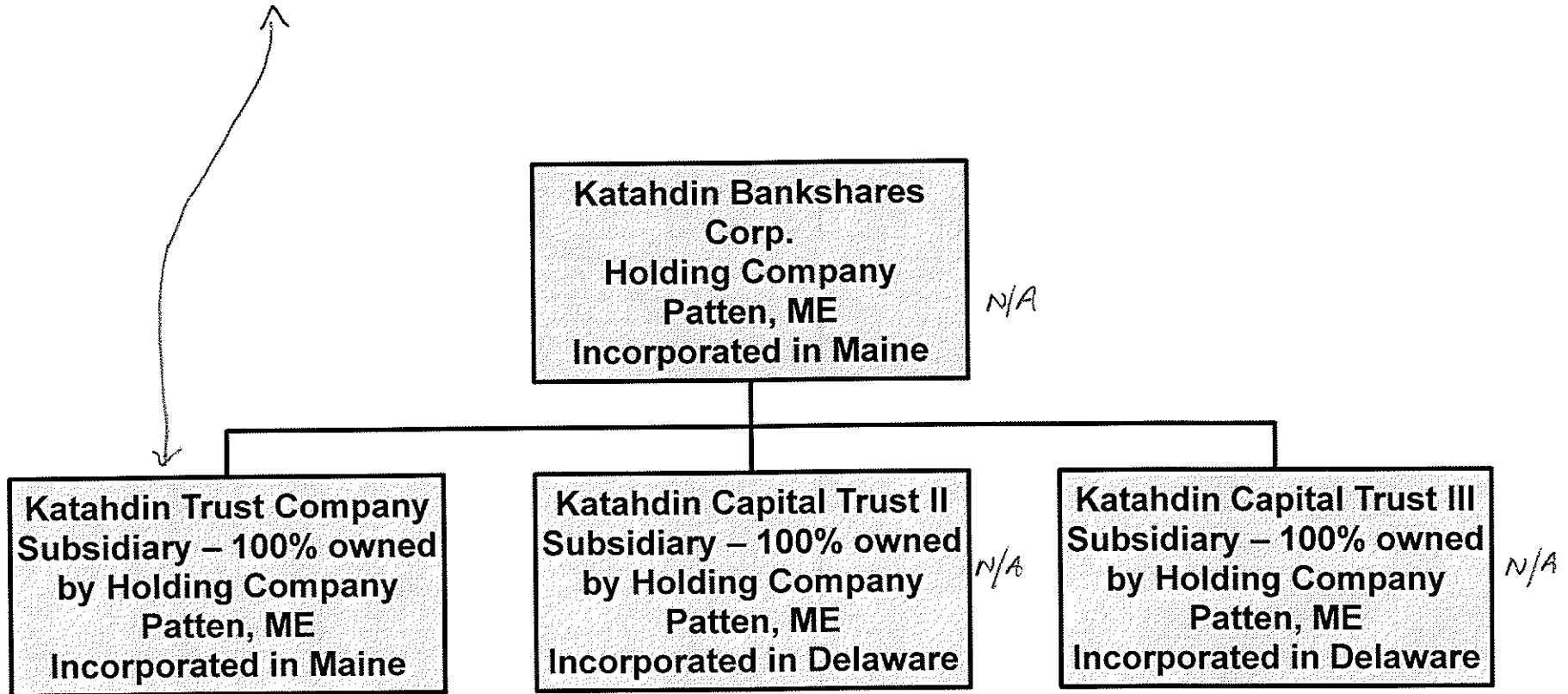
FR Y-6
For year-end December 31, 2018
Katahdin Bankshares Corp.
Main Street, P O Box 450
Patten, Maine 04765

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

Report Item 1b: Annual reports to shareholders
Enclosed

Report Item 2: Organization Chart
(1.)

The LEI is 549300PRPWDL1RI5M21



(2.) None

(3.) None

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 12/31/2018. Data reflects information that was received and processed through 01/06/2019.

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	1189913	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	

Report Item 3: Shareholders

(1) **CEDE & Co.**

New York, NY/USA

Country of Incorporation – United States of America

2,190,896 shares of Common Stock = 64.36%

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: | 64.36% 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. control of 1.02% of stock in Katahdin Bankshares Corp., c. Owner of 35.54% 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., c. 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 Management
3. Title/Position: a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Shareholder of Webber Group of Companies, d. Co-owner and Managing Member of Harnum Family, LLC, e. Co-owner and Managing Member 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 22.5% of stock in Webber Group Of Companies; d. owner of 50% of stock in Harnum Family, LLC, e. owner of 50% 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: Business Owner
 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 100% of stock in State of Granite, LLC.

1. Name & Address: **Marianna (Molly) Putnam Liddell**, Yarmouth, ME/USA
 2. Principal Occupation: Attorney, Pierce Atwood LLP
 3. Title/Position: a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Partner Pierce Atwood LLP
 4. % of each class: a. Does not own any stock in Katahdin Bankshares Corp., c. Owner of <5% in Pierce Atwood LLP

1. Name & Address: **Keith P. Bourgoin**, Hampden, ME/USA
 2. Principal Occupation: CPA
 3. Title/Position: a. Director of Katahdin Bankshares Corp., b. Director of Katahdin Trust Company, c. Owner and Managing Partner Haverlock, Estey & Curran LLC d. Owner and Managing Partner HEC – Hampden
 4. % of each class: a. Does not own any stock in Katahdin Bankshares Corp., c. Owner of 16.66% of stock in Haverlock, Estey & Curran CPA's, d. Owner of 16.66% stock in HEC- Hampden.

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, d. Director of Houlton Water Company, e. Director Maine Bankers Association
 4. % of each class: a. Owner of 1.83% 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 .22% 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, c. Director Aroostook Partnership
4. % of each class: a. Owner of .05% of stock of Katahdin Bankshares Corp.

1. Name & Address: **Krista K. Putnam**, Houlton, ME/USA
2. Principal Occupation: Banker
3. Title/Position: No position with holding company, Senior Vice President, Marketing
4. % of each class: Does not own any stock in Katahdin Bankshares Corp.



YEARS

2018

ANNUAL REPORT

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VOLUNTEER
SERVING OUR COMMUNITY
SINCE
1918
KATAHDIN

Thank You

**FOR BEING PART OF OUR JOURNEY
FOR 100 YEARS AND COUNTING**

2018 marked 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 180 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 so proud to be named a 2018 Best Places to Work in Maine.



**Best Places to
Work in ME**



DEAR FELLOW SHAREHOLDERS



Net income paid before dividends on preferred stock totaled \$7,197,000, a significant increase over the prior year's figure of \$4,353,000. There are several reasons for this increase, including a corporate tax benefit from the Tax Cuts and Jobs Act of 2017, a wider net interest margin, improved credit quality, as well as strong expense control.

Net interest income for the year rose to \$26,266,000, helped by increases in yields on loans and securities purchased. Non-interest income dropped slightly from \$4,421,000 to \$4,408,000. Service charges and fees on deposits grew slightly to \$1,999,000. Other fee income dropped by \$44,000 due to lower fees on commercial loan interest rate swaps. During 2018 we began offering mortgages sold to the secondary market, which, in time, we feel will add to our non-interest income.

In the past, I have reported on some of the Bank's strategic initiatives, beginning with local deposit growth. I am pleased to report that local deposits grew in 2018, by \$20.1 million. Local deposit growth is increasingly valuable as alternative wholesale funding costs have risen with several Federal Reserve rate hikes since December 2016. Core deposit growth, especially regular checking accounts, is a major priority for the Bank in 2019 and beyond. We have added staff to bolster this initiative, which has been a central theme internally.

Another area of focus is expense control. During 2018 total non-interest expenses ticked down by less than 1%, which is an outstanding result. This, along with the tax benefit, allowed a large portion of revenue growth to flow directly to net income. While this level of expense control will not likely continue, we remain focused on reducing our efficiency ratio over time by eliminating any unnecessary costs, streamlining procedures, and growing with greater operational efficiency. Efficient and intelligent use of technology will continue to play an important role in this effort.

Credit quality is always important to a successful bank. Becoming more selective in potential loans has helped improve portfolio quality even as we navigate challenging economic conditions in some of our markets and the industries we lend to. Total non-performing loans and past-due loans decreased year over year. Such improvement leads not only to a lower provision for loan losses, but also related benefits such as lower costs of collection and legal fees, management time handling problem assets that can better be spent in other areas, and lower FDIC premium assessments. While we are focused on achieving solid loan growth in 2019 and going forward, we will continue to emphasize credit quality.

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



Upward interest rate movement continued during 2018. With the aforementioned rate hikes by the Fed, deposit costs have increased, particularly for wholesale funding and negotiated rates. Rates for longer terms have not increased significantly, which has flattened or, at times, inverted the yield curve. During 2018 we managed through these conditions to a slight widening of our net interest margin, which we feel will be important to strive for in 2019. Fed actions and competitive market pricing will dictate how this plays out.

Since the passage of the Dodd-Frank Act in 2010 community banks have been encumbered with increasing regulatory burden as a result of the systemic risks posed by larger institutions. Regulations designed to affect the largest banks in the country have nonetheless "trickled down" to impact us as well. During 2018 we were pleased to see the enactment of the "Economic Growth, Regulatory Relief and Consumer Protection Act," which offers some alleviation of regulatory burden. Of particular benefit may be the asset threshold increase for holding companies, like ours, to \$3 billion to be considered Small Bank Holding Companies. This allows leverage to be used at the holding company to supply the Bank with capital for a variety of purposes. As this law is implemented by regulatory agencies over time, we're hopeful for some benefit across other areas of our operation as well.

Our employees are now owners as a result of our Employee Stock Ownership Plan (ESOP). We feel that as well as a strong employee benefit, employee ownership in the company aligns our people's interests with those of fellow shareholders. If and when our ESOP grows, our employees will think even more in terms of enhancing shareholder value.

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 received a lower level of proxies from shareholders. Your votes are important to

the Company; I hope that you please take the time to review the proxy and vote by mail, telephone or online.

As we continue to expand our operations throughout Maine, the addition of two new directors is an important step in ensuring our board representation reflects our statewide presence and director continuity. In December the appointment of Marianna Putnam Liddell, Esq. of Yarmouth and Keith P. Bourgoïn, CPA of Hampden demonstrates our commitment to having a board of directors diverse in both expertise and geographic location.

We are very proud of our 2018 Best Places to Work in Maine designation. This achievement is to the credit of every Katahdin Trust employee. I am grateful and honored to work with such a dedicated team that strives to provide our customers the best community banking has to offer. Their commitment extends to the communities we serve, as evidenced by the 7,600 hours of volunteer support they provided to 230 organizations and non-profits.

I would like to give a heartfelt thank you to you, our owners, as well as our employees, board of directors and the community at large for a wonderful 100th anniversary celebration. It is a privilege to support the banking needs of our friends and neighbors in northern Maine, greater Bangor and greater Portland. We look forward to doing so for the next one hundred years.

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.

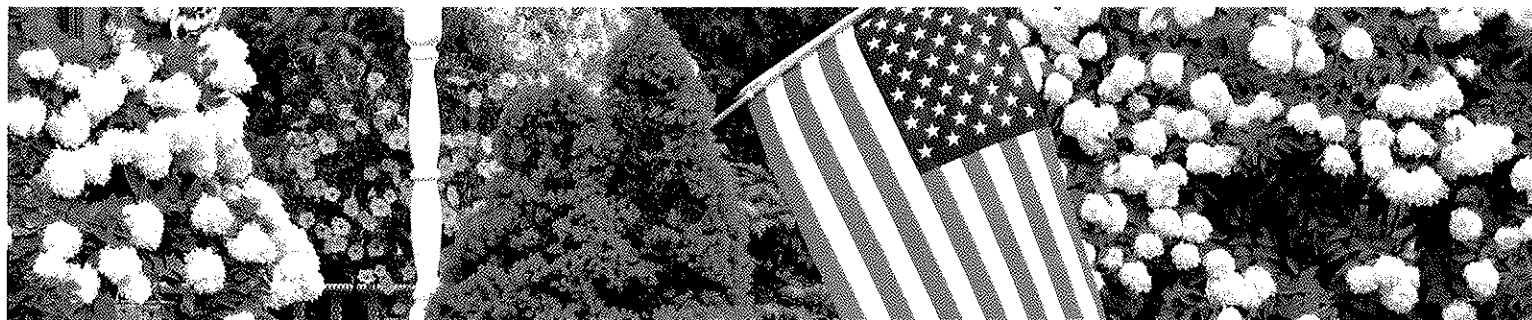


“

I started my relationship with Katahdin Trust in 2016 with one of my medical practices. Since then I have moved all of our personal and small family farm accounts to the bank. In addition, Katahdin Trust is the lender for our new orthopedic surgery center. I appreciate their personal service and attention to detail.”

GARRETT MARTIN, M.D.
Orthopedic Surgeon,
Down East Orthopedic Associates, P.A.
and Down East Surgery

Pictured with Angela T. Butler
Senior Vice President,
Commercial Services Officer
Katahdin Trust Company



OUR BOARD



STEVEN L. RICHARDSON
CHAIRMAN

Partner,
Richardson's True Value Hardware
Patten, Maine
Director since 1978



PETER F. BRIGGS

Retired from the
wholesale beverage industry.
Kennebunk, Maine and
Green Valley, Arizona
Director since 1995



RICHARD J. YORK, SR.
VICE CHAIRMAN

General Sales Manager,
York's of Houlton
Houlton, Maine
Director since 1997



RICHARD B. HARNUM, JR.

President,
Harnum Holdings
Bangor, Maine
Director since 2017



JON J. PRESCOTT
PRESIDENT & CEO

Katahdin Bankshares Corp.
and Katahdin Trust Company
Houlton, Maine
Director since 1997



MARIANNA
PUTNAM LIDDELL, ESQ.

Partner,
Pierce Atwood LLP
Yarmouth, Maine
Director since 2018



ROBERT E. ANDERSON

Chairman of the Board,
FA Peabody Company
Houlton, Maine
Director since 1989



KIMBERLEY A. NILES

Owner and Director,
State of Granite, LLC
Plaistow, New Hampshire
Director since 2015



KEITH P. BOURGOIN, CPA

Managing Partner,
Haverlock, Estey & Curran, LLC
Hampden, Maine
Director since 2018



PAUL R. POWERS

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

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

Krista K. Putnam

Senior Vice President

Marketing

OFFICERS

Tori A. Barber

Assistant Vice President,

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

Sarah L. Bowie

Vice President

Business Development 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

Samuel S. Clockedile

Marketing Officer

Albert "Joe" Clukey II

Vice President

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Retail Services Officer, Fort Fairfield

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Retail Services Officer, Ashland

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Assistant Vice President,

Branch Manager &

Retail Services Officer, Hampden

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Branch Manager &

Retail Services Officer,

Fort Kent & Eagle Lake

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Managed Assets Officer

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Senior Vice President

Commercial Services Officer

Leslie M. Gardner

Vice President

Retail Loans

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Branch Manager &

Retail Services Officer, Patten

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Vice President

Project Manager

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Assistant Vice President

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Vice President, Branch Manager &

Retail Services Officer, Presque Isle

Billi B. Griffith

Assistant Vice President

Retail Services

Jamie M. Haining

Vice President

Business Development Officer

Patricia A. Hersey

Vice President

Business Development Officer

Katherine H. Hill

Vice President

Bank Operations Manager

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Vice President

Compliance Officer

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Senior Commercial Services Assistant

Natasha R. McCarthy

Vice President

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

Rebecca Potter

Commercial Services Officer

Andrew L. Putnam

Vice President

Chief Information Officer

Sherry L. Roberts

Vice President

Business Development Officer

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Assistant Vice President,

Branch Manager & Retail Services

Officer, Oakfield & Island Falls

Sarah S. Silliboy

Assistant Vice President

BSA Officer

Peggy S. Smith

Vice President, Branch Manager &

Retail Services Officer,

Caribou & Van Buren

Rebecca J. Smith

Branch Manager & Retail Services

Officer, Bangor & Scarborough

Vicki J. Smith

Executive Assistant

Craig C. Staples

Vice President

Commercial Services Officer

Pamela J. Ward

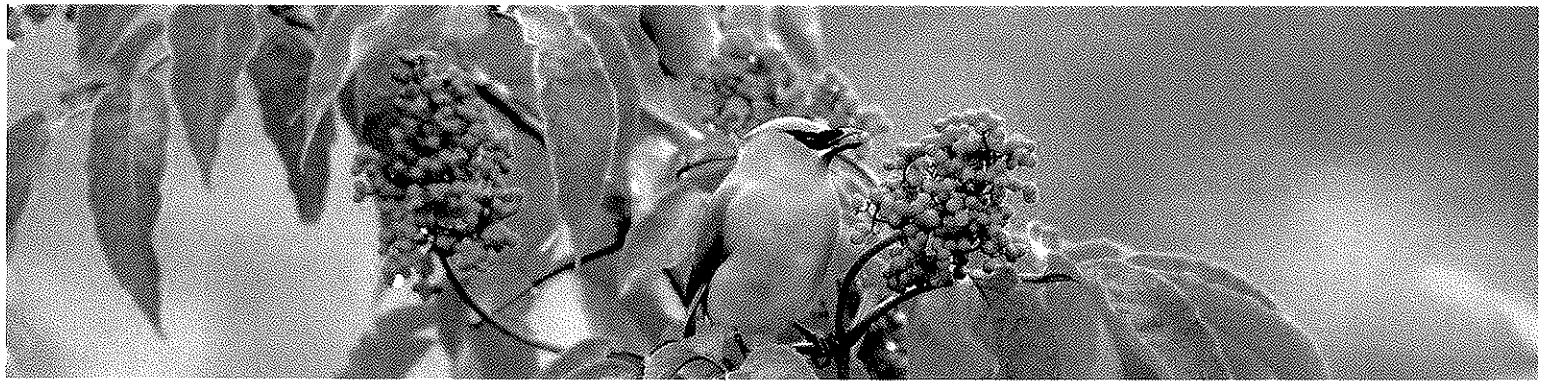
Assistant Vice President

Credit Control

Danelle L. Weston

Regional Vice President

Bangor Market



Ashley M. Andrews
Michelle L. Bagley
Jennifer L. Blaisdell
Rhonda A. Blanchette
Danielle L. Brewer
Jessica L. Buckley
Emily S. Bulley
Monica L. Campbell
Jennah L. Carver
Kelsey P. Charette
Wendy L. Clark
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Jane F. Conlogue
Mary J. Cook
Lindsay M. Corey
Tabitha J. Corey
Clarissa H. Crandall
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Kati Deane-Grant
Tory J. Delano
Carol A. Dow
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Lisa A. Dubois
Kimberly J. Embelton
April D. Emery
Kelly J. Emery
Valerie O. Estabrook
Sue A. Fox
Frederick E. Gagnon
Sarah J. Gardiner
Penny M. Garnett
Crystal A. Gastia
Vincent M. Gilmore
Jonathan P. Glazier
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Cathy J. Haley
Trecia M. Hanning
Virginia L. Hartin
Wendy L. Henderson
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Samantha M. Kearney
Kelly J. Kilcollins
Jennifer L. King
Michaela L. King
Janet L. Lane
Rosemary A. Langer
Yancy J. LaPointe
Dawn M. Larrabee
Denise G. Lease
Hannah E. Lee
Mark P. Levasseur
Crystal E. Levesque
Sharon J. Levesque
Teresa S. Lincoln
Nicole L. Lockhart
Tannis B. Lundin
Jeremy K. MacArthur
Karen L. MacDonald
Joshua L. MacFarlane
Ann M. Madore
Lita A. Madore
Brian A. Martin
Eunice M. McAfee
Megan K. McEndarfer
Arianna E. McGraw
Shelly L. McHatten
Elizabeth M. Michaud
Susan M. Miller
Courtney R. Milliard
Monique A. Montpetit
Abigail B. Moody
Whitney J. Moran
Timothy D. Morris
Lori J. Nadeau
Rhonda M. Nicholson
Julie A. O'Hara
Connie M. Ouellette
Robin M. Palmer
Whitney M. Palmer
Crystal L. Parent
Valerie J. Pelletier

Timothy W. Perry
Deborah L. Powers
Kenneth F. Prescott
Mari E. Remeschatis
Megan P. Robinson
Jasmine M. Rockwell
Scott A. Rossignol
Janet L. Saucier
Richard H. Schmidt III
Rachel C. Soucy
Abagale L. Stewart
Heidi J. Stewart
Dianne M. Tapley
Kathy A. Thompson
Vickey J. Tilley
Lana J. Tucker
Amy L. Turner
Marie D. Vincent
Jolene L. Wallace
Kristen V. West
Lauren E. West
Chelsea M. Whitaker
Susan M. White
Betty J. Willette
Lisa M. Willigar
Miranda B. Wotton
Crystal L. Wright
Emerson M. Wright
Mindi A. Yates

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

Devin J. Rolph
Tamara J. Wheeler

KATAHDIN FINANCIAL SERVICES

Bradley A. Berthiaume
Senior Vice President
Financial Consultant

Adam R. Bither
Kelly Jo Cole

Communities that **work**
together **thrive** together.

7,600
VOLUNTEER HOURS

230
LOCAL NON-PROFITS

OVER \$24,000 IN EMPLOYEE DONATIONS
TO BANK SPONSORED COMMUNITY CAUSES

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, 2018, KBS had consolidated total assets of \$803.1 million, total deposits of \$657.1 million, and total shareholders' equity of \$71.1 million. Following is an overview of the Company, its strategy, and the results of 2018 operations.

Our Business

The Bank was established in 1918 and celebrated 100 years of service in 2018. It 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 \$106.2 million as of December 31, 2018.

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 the following:

- Continue as a leading financial institution throughout Maine;
- Seek opportunities for profitable growth and expansion while increasing net interest income, enhancing non-interest income, and controlling operating costs;
- Provide stable long-term returns to our shareholders;
- To have a balanced loan portfolio which is served by an experienced team that meets customer needs throughout the Bank's market area.

The Bank has a strong commitment to small business and has held the preferred lender designation from the U.S. Small Business Administration for nearly seven years; a designation reserved for SBA's most experienced and trusted lenders with a proven record of small business performance and excellence; and in 2017 received the Outstanding Partner Award for originating a significant number of SBA guaranteed loans.

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 also recognizes the changes in customer preferences brought about through the use of various forms of technology, 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 and it is committed to developing and maintaining an engaged, well-trained workforce that is knowledgeable about the Bank's market area and its residents. The Bank's personnel reside in their respective market areas, and are equipped to provide high quality service. The Bank encourages and supports our staff to volunteer in their communities and each year they contribute significant hours to a variety of community organizations and causes.

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,	2018	2017	2016	2015	2014
Balance Sheet Data					
Total assets	\$ 803,119	\$ 794,638	\$ 754,012	\$ 702,289	\$ 667,112
Total investments ⁽¹⁾	96,319	90,445	88,965	74,836	60,597
Total loans	660,475	661,636	623,279	586,238	565,337
Allowance for loan losses	(5,856)	(6,048)	(6,032)	(5,330)	(5,899)
Total deposits	657,074	647,752	652,969	606,205	550,694
Shareholders' equity	71,057	66,799	64,415	62,357	71,086
Summary of Operations					
Interest and dividend income	\$ 33,172	\$ 30,803	\$ 29,350	\$ 27,512	\$ 27,031
Interest expense	6,906	5,341	4,281	3,861	4,240
Net interest income	26,266	25,462	25,069	23,651	22,791
Provision for loan losses	180	1,225	1,316	50	548
Net interest income after the provision for loan losses	26,086	24,237	23,753	23,601	22,243
Non-interest income before impairment of investment securities	4,408	4,421	4,464	3,884	3,568
Net impairment of investment securities	-	5	4	2	17
Non-interest expense	21,520	21,529	21,535	20,372	19,621
Income before income taxes	8,974	7,124	6,678	7,111	6,173
Income taxes	1,777	2,771	1,864	2,301	1,918
Net income	\$ 7,197	\$ 4,353	\$ 4,814	\$ 4,810	\$ 4,255
Less dividends on preferred stock	875	875	875	910	557
Net income available to common shareholders	\$ 6,322	\$ 3,478	\$ 3,939	\$ 3,900	\$ 3,698
Per Common Shares and Common Shares Outstanding					
Net income, basic ⁽²⁾	\$ 1.89	\$ 1.03	\$ 1.16	\$ 1.15	\$ 1.09
Net income, diluted ⁽²⁾	1.89	1.03	1.16	1.15	1.09
Book value ⁽³⁾	18.29	16.94	16.17	15.47	14.93
Tangible book value ⁽³⁾	16.59	15.24	14.48	13.80	13.26
Weighted average common shares outstanding: ⁽⁴⁾					
Basic	3,345,012	3,373,220	3,399,826	3,404,367	3,404,367
Diluted	3,345,012	3,373,220	3,399,826	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⁾	3,339,734	3,361,298	3,380,173	3,404,367	3,404,367
Selected Performance Ratios					
Return on average assets	.91%	0.55%	0.66%	0.70%	0.66%
Return on average common shareholders' equity	10.85	6.17	7.23	7.50	7.44
Net interest spread ⁽⁶⁾	3.40	3.33	3.56	3.62	3.66
Net interest margin ⁽⁷⁾	3.50	3.42	3.66	3.71	3.78
Efficiency ratio ⁽⁸⁾	70.16	72.06	72.93	73.99	74.42
Asset Quality Ratios					
Allowance for loan losses to period end loans	0.89	0.91%	0.97%	0.91%	1.04%
Allowance for loan losses to non-performing loans ⁽⁹⁾	92.72	84.76	39.57	61.71	50.24
Non-performing loans to period end loans ⁽⁹⁾	0.96	1.08	2.45	1.47	2.07
Non-performing assets to total assets ⁽¹⁰⁾	0.79	0.95	2.11	1.31	1.83
Capital Ratios (Katahdin Trust Company)					
Total risk-based capital ratio	13.40%	12.64%	13.02%	13.34%	13.38%
Tier 1 risk-based capital ratio	12.42	11.63	11.95	12.33	12.23
Common equity tier 1 risk-based capital ratio	12.42	11.63	11.95	12.33	-
Tier 1 capital ratio (Leverage ratio)	9.42	8.88	9.15	9.48	9.68
Other Data					
Number of full and limited service banking offices	16	16	19	19	19
Number of full-time equivalent employees	173	174	186	195	196
Katahdin Financial Services Assets Under Management	\$ 106,190	\$ 105,280	\$ 90,160	\$ 83,500	\$ 87,200

(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.

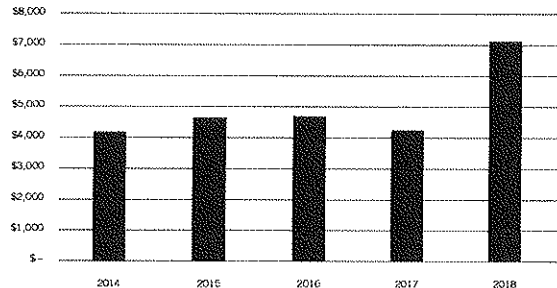
COMPANY OVERVIEW AND RESULTS OF OPERATIONS

Net Income

Net Income before preferred stock dividends reached \$7,197,000 in 2018, exceeding last year by \$2.8 million or 39.5%. A large percentage of this increase can be attributable to the Tax Cuts and Jobs Act of 2017. However, when neutralizing the negative \$438,000 tax adjustment in 2017 earnings and the positive 2018 impact from the reduced tax rate of \$1,152,000, core earnings grew by \$1,254,000. This core earnings growth can be attributed to an expansion in net interest income, improved asset quality, and a slight decline in overall operating expenses in 2018.

Diluted earnings per common share totaled \$1.89, up from \$1.03 per share for reasons previously stated. Return on Average Assets ended at 0.91% compared to 0.55% in 2017. Return on Average Common Equity was 10.85% compared to 6.17% in 2017.

NET INCOME (\$000)



Net Interest Income

Net interest income reached \$26,266,000, exceeding the prior year by \$804,000 or 3.2%. Net interest income reflects revenues generated through income from earning assets plus loan fees, less interest paid on interest-bearing deposits and borrowings. Growth was accomplished through a widening of our average net interest spread to 3.40% in 2018, compared to the prior year average spread of 3.33%. Increases in short term interest rates over the last two years have allowed yields on both new volumes of investments and loans as well as variable-rate loans to reprice upward compared to the portfolio yield. Overall, our interest rate sensitivity remains balanced but will continue to be challenged with increasing costs of funding. Managing through the current interest rate cycle continues to be a top priority.

Provision and Asset Quality

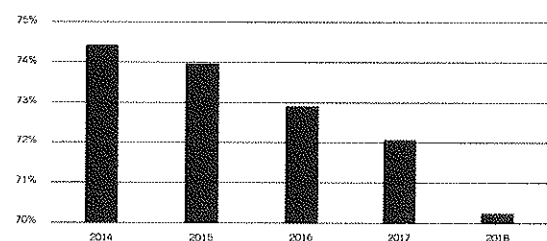
Asset quality improvements translated to bottom line earnings in 2018. Overall asset quality is sound. Non-performing loans to period end loans ended the year at 0.96%, a decrease from 1.08% at the end of 2017. Non-performing assets to total assets ended the year at 0.79%, down from 0.96% at year-end 2017. The allowance for loan losses was funded with a provision of \$180,000 in 2017, as compared to \$1,225,000 last year. As a result, our allowance for loan losses to period end loans ratio ended at 0.89% as compared to 0.91% at year-end 2017.

Additionally, other property and real estate owned assets remained very low in 2018, reducing the cost to carry assets through the collection process last year. 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 \$4,408,000, a slight decrease of \$13,000 from 2017. 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, but earned lower income than the prior year in revenues from interest rate swaps put in place with commercial real estate loan customers. Management continues to look for ways to enhance non-interest income such as introducing a product in 2018 that allows for the sale and servicing of 1-4 family residential mortgages which will complement our current lineup of portfolio residential lending products.

EFFICIENCY RATIO



Non-interest expense dropped by \$9,000 to \$21,520,000, marking the second year in a row of operating expense reduction. The Bank has implemented strategies to reduce overhead expenses that have yielded results. Efficiency can be gained by both operating expense reduction and by creating new revenue generation. The Efficiency Ratio improved to 70.16% as of year-end 2018, with a trend of reduction over the last few years. There continues to be room for improvement, and we'll continue to look for opportunities to both grow revenue and operate more efficiently.

COMPANY OVERVIEW AND RESULTS OF OPERATIONS

Assets

Total assets reached \$803,119,000, representing a modest increase over the prior year of \$8.5 million or 1.1%. Much of this growth came from growth in investments of \$5.9 million to a portfolio level of \$96.3 million, as customer deposit growth outpaced loan generation in 2018.

Loans

Total loans declined year over year to \$660,475,000, a reduction of \$1.16 million. Although loans did not increase during 2018, loan growth continues to be a high priority. Commercial real estate loans grew in 2018 and continue to be our largest asset category reaching \$342,993,000, representing an increase of \$11.6 million. Areas of contraction were commercial equipment loans totaling \$161,025,000, down by \$3.4 million; municipal loans totaling \$6,900,000, down by \$3.3 million; and residential 1-4 family loans totaling \$138,583,000 which were down from last year by \$2.8 million. Approximately 77.5% of the Bank's loan portfolio consists of municipal, commercial and commercial real estate loans.

Deposits

Total deposits grew by \$9.3 million, reaching \$657,074,000. Within this number local deposits grew \$20.1 million. Local checking and savings grew by \$10.7 million last year, while local money markets and certificates of deposit grew by \$9.4 million. Growth came from local deposit initiatives throughout our market area. Since loans did not grow, this funding was used to pay down higher cost national certificates of deposits and secured wholesale borrowings combined by \$17 million.

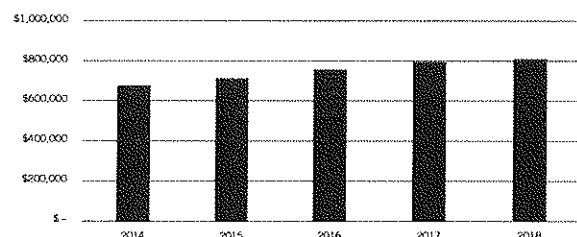
Brokered CDs and secured borrowings continue to account for a significant portion of our funding source. These sources of funds can increase in cost more rapidly than local deposits in a rising rate environment. However, they also enable the Bank to fund asset growth when our ability to raise local deposits 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

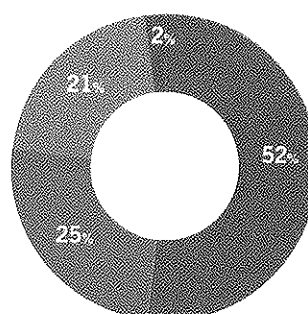
Total Shareholders' Equity stood at \$71,057,000, an increase of \$4,258,000 from year end 2017. Capital ratios for the Bank grew in 2018 and continue to remain well above the minimums to be well-capitalized per regulatory capital requirements. The Bank's leverage ratio at year-end 2018 was 9.42%, compared to 8.88% at the end of 2017. Total risk-based capital stood at 13.40% as compared to 12.64% in 2017.

Tangible book value of \$16.59 was an increase of \$1.35 or 8.9% over year-end 2017. The Company paid out a total of \$0.43 per share in common stock dividends representing a 22.8% payout ratio of 2018 net income available to common shareholders.

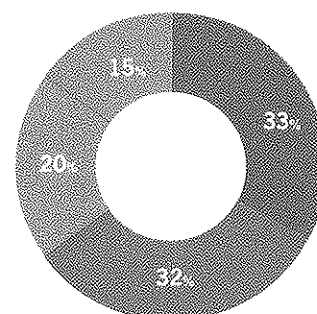
ASSETS (\$000)



LOAN MIX



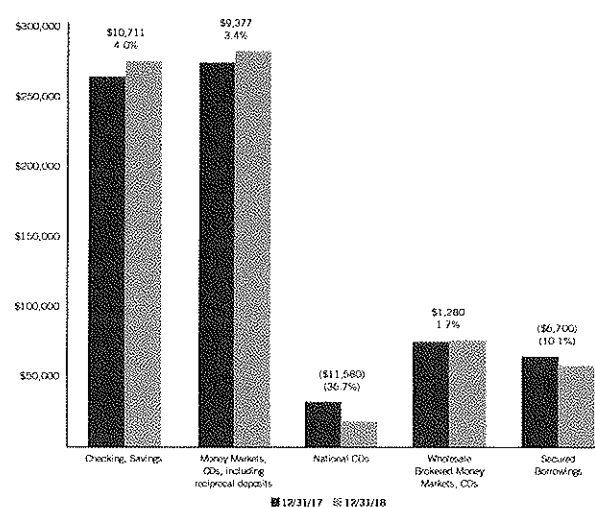
DEPOSIT SOURCES



- Commercial Real Estate
- Commercial Loans
- Residential 1-4 Family Real Estate
- Consumer Installment Loans

- Consumer
- Commercial
- Public & Non-Profit
- Wholesale

DEPOSIT TREND (\$000)



INDEPENDENT AUDITOR'S REPORT



Board of Directors and Shareholders
Katahdin Bankshares Corp. and Subsidiary

We have audited the accompanying consolidated financial statements of Katahdin Bankshares Corp. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, 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, 2018 and 2017, 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 1, 2019

CONSOLIDATED BALANCE SHEETS

December 31, 2018 and 2017

ASSETS	2018	2017
Cash and due from banks	\$ 5,790,000	\$ 5,620,000
Interest bearing deposits in banks	11,586,000	8,364,000
Securities available-for-sale	93,148,000	86,872,000
Securities held-to-maturity	7,000	9,000
Federal Home Loan Bank stock, at cost	3,164,000	3,564,000
Loans receivable, net of allowance for loan losses of \$5,856,000 in 2018 and \$6,048,000 in 2017	654,619,000	655,588,000
Bank premises and equipment, net	10,558,000	11,049,000
Goodwill	5,559,000	5,559,000
Other assets	18,688,000	18,013,000
	<u>\$ 803,119,000</u>	<u>\$ 794,638,000</u>
LIABILITIES AND SHAREHOLDERS' EQUITY	2018	2017
Deposits		
Demand deposits	\$ 119,166,000	\$ 114,730,000
NOW and money market deposits	289,279,000	275,938,000
Savings deposits	63,487,000	63,568,000
Certificates of deposit	185,142,000	193,516,000
Total deposits	657,074,000	647,752,000
Advances from Federal Home Loan Bank	58,801,000	65,867,000
Other borrowed funds	400,000	118,000
Accrued expenses and other liabilities	8,570,000	6,885,000
Junior subordinated debentures	7,217,000	7,217,000
Total liabilities	732,062,000	727,839,000
Shareholders' equity		
Preferred stock, 20,000 shares authorized		
Series D, 4,000 shares issued and outstanding	9,953,000	9,859,000
Common stock, \$.10 par value; 20,000,000 shares authorized, 3,404,367 shares issued and outstanding on December 31, 2018 and 2017	339,000	339,000
Surplus	8,810,000	8,778,000
Undivided profits	53,931,000	49,141,000
Accumulated other comprehensive income (loss)		
Net unrealized depreciation on securities available-for-sale, net of deferred income taxes	(1,255,000)	(778,000)
Net unrealized gain on derivative instruments, net of deferred income taxes	256,000	17,000
Unearned ESOP shares	(977,000)	(557,000)
Total shareholders' equity	71,057,000	66,799,000
	<u>\$ 803,119,000</u>	<u>\$ 794,638,000</u>

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

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2018 and 2017

	2018	2017
Interest and dividend income		
Loans	\$ 30,946,000	\$ 28,702,000
Investment securities	2,209,000	2,093,000
Other interest-earning assets	17,000	8,000
Total interest and dividend income	33,172,000	30,803,000
Interest expense		
Deposits	5,141,000	4,464,000
Borrowed funds and junior subordinated debentures	1,765,000	877,000
Total interest	6,906,000	5,341,000
Net interest income	26,266,000	25,462,000
Provision for loan losses	180,000	1,225,000
Net interest income after provision for loan losses	26,086,000	24,237,000
Noninterest income		
Service charges and fees	1,999,000	1,968,000
Other	2,409,000	2,453,000
Total noninterest income before impairment of investment securities	4,408,000	4,421,000
Total other-than temporary impairment losses	(14,000)	(9,000)
Portion of loss recognized in other comprehensive income	14,000	4,000
Net impairment losses recognized in net income	-	(5,000)
Net noninterest income	4,408,000	4,416,000
Noninterest expenses		
Salaries and employee benefits	13,083,000	12,594,000
Occupancy and equipment expense	2,782,000	3,088,000
Data processing	1,935,000	1,796,000
Marketing and donations	920,000	830,000
FDIC and state assessments	408,000	648,000
Other general and administrative	2,392,000	2,573,000
Total noninterest expenses	21,520,000	21,529,000
Income before income taxes	8,974,000	7,124,000
Income tax expense	1,777,000	2,771,000
Net income	\$ 7,197,000	\$ 4,353,000
Less dividends on preferred stock	\$ 875,000	\$ 875,000
Net income available to common shareholders	\$ 6,322,000	\$ 3,478,000
Basic earnings per common share	\$ 1.89	\$ 1.03
Diluted earnings per common share	\$ 1.89	\$ 1.03
Diluted weighted average common shares outstanding	3,345,012	3,373,220

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31, 2018 and 2017

	2018	2017
Net Income	\$ 7,197,000	\$ 4,353,000
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	(604,000)	307,000
Reclassification adjustment for losses realized in net income	-	5,000
Tax effect	127,000	(106,000)
Net change in unrealized depreciation on available-for-sale securities, net of tax	(477,000)	206,000
Unrealized gain on derivative instruments, net of tax	239,000	334,000
Total other comprehensive (loss) income	(238,000)	540,000
Comprehensive income	\$ 6,959,000	\$ 4,893,000

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

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2018 and 2017

	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, 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
Net income	-	-	-	7,197,000	-	-	-	7,197,000
Change in net unrealized depreciation on securities available-for-sale, net of deferred income taxes of \$127,000	-	-	-	-	(477,000)	-	-	(\$477,000)
Change in net unrealized gain on derivative instruments, at fair value, net of taxes of \$50,000	-	-	-	-	-	239,000	-	239,000
Total comprehensive income	-	-	-	7,197,000	(477,000)	239,000	-	6,959,000
Cash dividends declared on common stock, \$0.43 per share	-	-	-	(1,438,000)	-	-	-	(1,438,000)
Accretion on preferred stock issuance	94,000	-	-	(94,000)	-	-	-	-
Cash dividends declared on preferred stock	-	-	-	(875,000)	-	-	-	(875,000)
Shares purchased by ESOP (32,300 shares)	-	-	-	-	-	-	(529,000)	(529,000)
Common stock held by ESOP committed to be released (10,279 shares)	-	-	32,000	-	-	-	109,000	141,000
Balance, December 31, 2018	\$ 9,953,000	\$ 339,000	\$ 8,810,000	\$ 53,931,000	\$ (1,255,000)	\$ 256,000	\$ (977,000)	\$ 71,057,000

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2018 and 2017

	2018	2017
Cash flows from operating activities		
Net income	\$ 7,197,000	\$ 4,353,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,870,000	1,921,000
Net amortization of securities	278,000	276,000
Provision for loan losses	180,000	1,225,000
Provision for losses on other real estate owned	56,000	48,000
Amortization of investments in limited partnerships	-	69,000
Impairment of investment securities	-	5,000
Deferred income tax provision (benefit)	(69,000)	154,000
Increase in cash value of life insurance	(318,000)	(330,000)
Loss on sale of other real estate and property owned	24,000	212,000
ESOP compensation expense	141,000	87,000
(Increase) decrease in accrued income receivable and other assets	(321,000)	297,000
Increase (decrease) in accrued expenses and other liabilities	1,022,000	(350,000)
Net cash provided by operating activities	10,060,000	7,967,000
Cash flows from investing activities		
Additions to premises and equipment	(695,000)	(504,000)
Loan originations and principal collections, net	759,000	(39,858,000)
Purchase of securities available-for-sale	(21,860,000)	(11,178,000)
Maturities of securities available-for-sale	14,702,000	11,608,000
Maturities of securities held-to-maturity	2,000	3,000
Proceeds from sales of other real estate and property owned	328,000	400,000
Redemption of FHLB stock	2,065,000	308,000
Purchase of FHLB stock	(1,665,000)	(2,190,000)
Net cash used by investing activities	(6,364,000)	(41,411,000)
Cash flows from financing activities		
Net increase (decrease) in deposits	9,322,000	(5,217,000)
Net decrease in securities sold under agreements to repurchase	(118,000)	(771,000)
Net increase in short-term borrowings	31,645,000	64,700,000
Repayment of long-term debt	(38,711,000)	(20,011,000)
Net increase in other borrowings	400,000	-
Cash dividends paid on preferred stock	(875,000)	(875,000)
Cash dividends paid on common stock	(1,438,000)	(1,350,000)
Cash provided to ESOP for purchase of shares	(529,000)	(371,000)
Net cash (used) provided by financing activities	(304,000)	36,105,000
Net increase in cash and cash equivalents	3,392,000	2,661,000
Cash and cash equivalents, beginning of year	13,984,000	11,323,000
Cash and cash equivalents, end of year	\$ 17,376,000	\$ 13,984,000
Supplementary cash flow information:		
Interest paid on deposits and borrowed funds	\$ 6,808,000	\$ 5,270,000
Income taxes paid	1,802,000	2,405,000
Noncash transactions		
Transfer from loans to other real estate and property owned	30,000	292,000
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, 2018 and 2017

Nature of Business

Katahdin Bankshares Corp. (the Company) is a bank holding company. A subsidiary, Katahdin Trust Company (the Bank), is a statechartered 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 9).

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 other 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 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 homogenous loans are collectively evaluated for impairment.

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

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

Credit Related Financial Instruments

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

1. Summary of Significant Accounting Policies (cont.)

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. The Company releases income tax effects from accumulated other comprehensive income when the associated transaction is recognized in earnings.

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, 2015 through 2017.

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 February 2016, FASB issued Accounting Standards Update (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 and does not anticipate it will 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, 2021, 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. The Company has formed an implementation committee for ASU No. 2016-13. To date, a third-party vendor has been selected and the committee is working through modeling and calculations.

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 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

1. Summary of Significant Accounting Policies (cont.)

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 did 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 ASU 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.

In July 2018, FASB issued ASU No. 2018-11, *Leases - Targeted Improvements*, to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU No. 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU No. 2016-02. The adoption of ASU No. 2018-11 is not expected to have a material effect on the Company's consolidated financial statements.

In August 2018, FASB issued ASU No. 2018-13, *Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. ASU No. 2018-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted. Entities are also allowed to elect early adoption of the eliminated or modified disclosure requirements and delay adoption of the new disclosure requirements until their effective date. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company's consolidated financial statements.

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 \$166,000 and \$313,000 as of December 31, 2018 and 2017, 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:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2018				
Securities Available-for-Sale				
U.S. Treasury securities	\$ 1,989,000	\$ -	\$ (16,000)	\$ 1,973,000
State and municipal	10,604,000	97,000	(88,000)	10,613,000
Corporate bonds	2,008,000	-	(75,000)	1,933,000
Mortgage-backed and CMO's	79,636,000	374,000	(1,796,000)	78,214,000
Other securities	500,000	-	(85,000)	415,000
Total securities available-for-sale	\$ 94,737,000	\$ 471,000	\$ (2,060,000)	\$ 93,148,000
Securities Held-to-Maturity				
Mortgage-backed and CMO's	\$ 7,000	\$ -	\$ -	\$ 7,000
Total securities held-to-maturity	\$ 7,000	\$ -	\$ -	\$ 7,000

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
2017				
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
Other 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

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, 2018:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Corporate bonds	\$ -	\$ -	\$ 425,000	\$ (75,000)	\$ 425,000	\$ (75,000)
Mortgage-backed and CMO's	5,278,000	(27,000)	53,454,000	(1,769,000)	58,732,000	(1,796,000)
U.S. Treasury securities	-	-	1,973,000	(16,000)	1,973,000	(16,000)
State and municipal	642,000	(2,000)	5,933,000	(86,000)	6,575,000	(88,000)
Other securities	-	-	415,000	(85,000)	415,000	(85,000)
Total temporarily impaired securities	\$ 5,920,000	\$ (29,000)	\$ 62,200,000	\$ (2,031,000)	\$ 68,120,000	\$ (2,060,000)

At December 31, 2018, unrealized losses within the other 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-nine individual securities of which sixty-two had continuous losses for more than one year. Unrealized losses within the state and municipal bonds category relate to fifteen individual securities of which thirteen 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. Unrealized losses within the U.S. Treasury securities category relate to one security 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, 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)
Other 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)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

3. Securities (cont.)

At December 31, 2017, unrealized losses within the other 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.

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, 2018 and 2017, 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, 2018 and 2017, and recognized OTTI write-downs related to credit loss of this security of \$5,000 for the year ended December 31, 2017. No write-down related to credit loss of this security was recognized as a result of the internal analysis performed for the year ended December 31, 2018.

At December 31, 2018 and 2017, securities with a fair value of \$33,625,000 and \$33,261,000, 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 securities by contractual maturity at December 31, 2018 follow:

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within 1 year	\$ 4,458,000	\$ 4,378,000	\$ -	\$ -
Over 1 year through 5 years	25,613,000	25,173,000	3,000	3,000
Over 5 years through 10 years	18,238,000	17,960,000	4,000	4,000
Over 10 years	45,928,000	45,222,000	-	-
Other securities	500,000	415,000	-	-
	<u>\$ 94,737,000</u>	<u>\$ 93,148,000</u>	<u>\$ 7,000</u>	<u>\$ 7,000</u>

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

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

4. Loans

A summary of the loan balances are as follows:

	2018	2017
Mortgage loans on real estate		
Residential 1-4 family	\$ 138,583,000	\$ 141,429,000
Commercial	342,993,000	331,373,000
	<u>481,576,000</u>	<u>472,802,000</u>
Commercial loans	161,028,000	164,431,000
Municipal loans	6,892,000	10,184,000
Consumer installment loans	9,945,000	13,155,000
Business credit cards	365,000	387,000
Subtotal	<u>659,806,000</u>	<u>660,959,000</u>
Less: Allowance for loan losses	5,856,000	6,048,000
Add: Net deferred loan costs	669,000	677,000
Loans, net	<u>\$ 654,619,000</u>	<u>\$ 655,588,000</u>

The following tables present the allowance for loan losses and select loan information for the years ended December 31, 2018 and 2017:

	Commercial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	2018 Total
Allowance for loan losses						
Beginning balance	\$ 2,502,000	\$ 3,100,000	\$ 221,000	\$ 74,000	\$ 151,000	\$ 6,048,000
Provision for (reduction of) loan losses	(345,000)	193,000	6,000	(29,000)	355,000	180,000
Loans charged off	(365,000)	(30,000)	(34,000)	(12,000)	-	(441,000)
Recoveries of loans previously charged off	49,000	17,000	1,000	2,000	-	69,000
Ending balance	<u>\$ 1,841,000</u>	<u>\$ 3,280,000</u>	<u>\$ 194,000</u>	<u>\$ 35,000</u>	<u>\$ 506,000</u>	<u>\$ 5,856,000</u>
Individually evaluated for impairment	\$ 51,000	\$ 300,000	\$ 18,000	\$ 1,000	\$ -	\$ 370,000
Collectively evaluated for impairment	\$ 1,790,000	\$ 2,980,000	\$ 176,000	\$ 34,000	\$ 506,000	\$ 5,486,000
Loans						
Ending balance	\$ 168,285,000	\$ 342,993,000	\$ 138,583,000	\$ 9,945,000		\$ 659,806,000
Individually evaluated for impairment	\$ 2,705,000	\$ 2,745,000	\$ 1,039,000	\$ 74,000		\$ 6,563,000
Collectively evaluated for impairment	\$ 165,580,000	\$ 340,248,000	\$ 137,544,000	\$ 9,871,000		\$ 653,243,000

	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)	-	1,225,000
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	<u>\$ 2,502,000</u>	<u>\$ 3,100,000</u>	<u>\$ 221,000</u>	<u>\$ 74,000</u>	<u>\$ 151,000</u>	<u>\$ 6,048,000</u>
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

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

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

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

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

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, 2018 and 2017:

Commercial Credit Risk Exposure Credit Risk Profile by Internally Assigned Grade

2018	Commercial	Commercial Real Estate
Pass	\$ 158,186,000	\$ 323,877,000
Special mention	5,481,000	16,810,000
Substandard	4,618,000	2,306,000
Doubtful	-	-
Loss	-	-
2018 Total	\$ 168,285,000	\$ 342,993,000

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

Consumer Credit Exposure Credit Risk Profile by Internally Assigned Grade

2018	Residential Real Estate	Consumer-Installment	Consumer-Indirect Installment
Pass	\$ 137,781,000	\$ 5,068,000	\$ 4,854,000
Substandard	802,000	23,000	-
2018 Total	\$ 138,583,000	\$ 5,091,000	\$ 4,854,000

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

The following presents an aging analysis of past due loans as of December 31, 2018 and 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
2018								
Commercial	\$ 343,000	\$ 206,000	\$ 1,392,000	\$ 1,941,000	\$ 166,344,000	\$ 168,285,000	\$ 2,003,000	\$ 39,000
Commercial real estate	894,000	83,000	-	977,000	342,016,000	342,993,000	842,000	-
Residential real estate	297,000	90,000	421,000	808,000	137,775,000	138,583,000	923,000	7,000
Consumer – installment	-	-	-	-	5,091,000	5,091,000	23,000	-
Consumer – indirect installment	65,000	7,000	30,000	102,000	4,752,000	4,854,000	28,000	30,000
2018 Total	\$ 1,599,000	\$ 386,000	\$ 1,843,000	\$ 3,828,000	\$ 655,978,000	\$ 659,806,000	\$ 3,819,000	\$ 76,000
2017								
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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

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, 2018 and 2017 were \$1,027,000 and \$303,000, respectively. Loans restructured due to credit difficulties that are now performing were \$2,722,000 and \$2,573,000 at December 31, 2018 and 2017, respectively.

At December 31, 2018 and 2017, the allowance related to TDRs was \$313,000 and \$243,000, 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, 2018 and 2017.

In 2018, three commercial loans did not perform according to the TDR terms and were subsequently charged off or transferred to OREO in the combined amount of \$97,000. In 2017, there were no loans that did not perform according to the TDR terms and were subsequently charged off or transferred to OREO.

The following is a summary of TDRs (accruing and non-accruing) by portfolio segment modified during the years ended December 31, 2018 and 2017:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Current Balance
2018				
Commercial	12	\$ 1,037,000	\$ 1,063,000	\$ 987,000
Commercial real estate	1	41,000	41,000	40,000
2018 Total	13	\$ 1,078,000	\$ 1,104,000	\$ 1,027,000
2017				
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

The following is a summary of TDRs (accruing and non-accruing) by portfolio segment as of December 31, 2018 and 2017:

	Number of Contracts	Current Balance	Related Allowance
2018			
Commercial	27	\$ 1,599,000	\$ 3,000
Commercial real estate	33	2,667,000	301,000
Residential real estate	3	568,000	9,000
Consumer	2	51,000	-
2018 Total	65	\$ 4,885,000	\$ 313,000
2017			
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

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, 2018 and 2017:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Interest Income Recognized
2018				
With no related allowance recorded:				
Commercial	\$ 2,245,000	\$ 2,245,000	\$ -	\$ 36,000
Commercial real estate	1,830,000	1,830,000	-	129,000
Residential real estate	828,000	828,000	-	31,000
Consumer	51,000	51,000	-	3,000
With an allowance recorded:				
Commercial	\$ 460,000	\$ 460,000	\$ 51,000	\$ 24,000
Commercial real estate	915,000	915,000	300,000	33,000
Residential real estate	211,000	211,000	18,000	2,000
Consumer	23,000	23,000	1,000	-
2018 Total:	\$ 2,705,000	\$ 2,705,000	\$ 51,000	\$ 60,000
Commercial	2,745,000	2,745,000	300,000	162,000
Residential real estate	1,039,000	1,039,000	18,000	33,000
Consumer	74,000	74,000	1,000	3,000
2017				
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:	\$ 2,635,000	\$ 2,635,000	\$ 430,000	\$ 87,000
Commercial	3,018,000	3,018,000	218,000	146,000
Commercial real estate	882,000	882,000	22,000	4,000
Consumer	105,000	105,000	10,000	5,000

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

	2018	2017
Impaired loans without a valuation allowance	\$ 4,954,000	\$ 3,571,000
Impaired loans with a valuation allowance	1,609,000	3,069,000
Total impaired loans	\$ 6,563,000	\$ 6,640,000
Valuation allowance related to impaired loans	\$ 370,000	\$ 680,000
Average investment in impaired loans	\$ 6,647,000	\$ 9,311,000

As of December 31, 2018 and 2017, there were four and five mortgage loans, respectively, collateralized by residential real estate in the process of foreclosure with a total balance of \$217,000 and \$227,000, respectively.

5. Bank Premises and Equipment

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

	2018	2017
Land	\$ 2,740,000	\$ 2,740,000
Buildings	11,460,000	11,530,000
Equipment	13,432,000	12,837,000
Leasehold improvements	1,112,000	1,112,000
Construction in progress	69,000	-
	28,813,000	28,219,000
Accumulated depreciation	(18,255,000)	(17,170,000)
	\$ 10,558,000	\$ 11,049,000

6. Deposits

At December 31, 2018, the scheduled maturities of time deposits are as follows:

2019	\$ 125,404,000
2020	23,565,000
2021	16,082,000
2022	11,139,000
2023 and thereafter	8,952,000
	\$ 185,142,000

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

6. Deposits (cont.)

Time deposit accounts in denominations that met or exceeded the insured limit were \$18,603,000 and \$18,439,000 at December 31, 2018 and 2017, respectively.

7. 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 \$52,156,000 and \$55,167,000 at December 31, 2018 and 2017, respectively, mature through August 2023. At December 31, 2018 and 2017, the interest rates on fixed-rate advances ranged from 0.00 to 2.87 percent. At December 31, 2018 and 2017, the weighted-average interest rates on fixed-rate advances were 2.17 percent and 1.59 percent, respectively.

The floating rate advance of \$6,645,000 at December 31, 2018 matures in January 2019. At December 31, 2018, the interest rate on the floating rate advance was 2.68 percent. The floating rate advance of \$10,700,000 at December 31, 2017 matured in January 2018. At December 31, 2017, the interest rate on the floating rate advance was 1.59 percent.

At December 31, 2018 and 2017, 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, 2018 are as follows:

2019	\$ 29,645,000
2020	17,500,000
2021	6,500,000
2022	2,500,000
2023	2,656,000

8. Other Borrowed Funds

Other borrowed funds of \$118,000 at December 31, 2017 consist of securities sold under agreements to repurchase. At December 31, 2018, the Company did not have any 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, securities with a fair value of \$118,000, were pledged to secure other borrowed funds.

Information concerning securities sold under agreements to repurchase for the years ended December 31, 2018 and 2017 is summarized as follows:

	2018	2017
Average balance during the year	\$ 72,000	\$ 270,000
Average interest rate during the year	0.10%	0.10%
Maximum month-end balance during the year	\$ 120,000	\$ 769,000

At December 31, 2018, other borrowed funds consisted of short-term borrowings maturing June 2019 under a \$1,000,000 line of credit.

At December 31, 2018 and 2017, the Company also had \$18,000,000 and \$8,500,000, respectively, available under lines of credit with other banks which were in addition to the line of credit disclosed in Note 7. There were no advances outstanding at December 31, 2018 or 2017.

9. 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.

10. Income Taxes

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

	2018	2017
Current tax provision		
Federal	\$ 1,704,000	\$ 2,504,000
State	142,000	113,000
	1,846,000	2,617,000
Deferred federal tax provision (benefit)	(69,000)	154,000
	\$ 1,777,000	\$ 2,771,000

The income tax provision (benefit) differs from the expense that would result from applying federal statutory rates (21% in 2018 and 34% in 2017) to income before income taxes, as follows:

	2018	2017
Computed tax expense	\$ 1,884,000	\$ 2,422,000
Increase (reduction) in income taxes resulting from:		
Tax exempt interest	(101,000)	(166,000)
State taxes, net of federal benefit	112,000	74,000
Income from life insurance	(67,000)	(112,000)
Preferred stock dividends	(2,000)	(5,000)
Tax credits, net of investment amortization	(55,000)	-
Change in federal tax rate	-	271,000
Other	6,000	287,000
	\$ 1,777,000	\$ 2,771,000

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:

	2018	2017
Deferred tax assets		
Other-than-temporary impairment of investment securities	\$ 46,000	\$ 46,000
Allowance for loan losses	1,230,000	1,270,000
Employee benefit plans	556,000	511,000
Net unrealized loss on securities available-for-sale	334,000	207,000
Other	39,000	51,000
	2,205,000	2,085,000

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

10. Income Taxes (cont.)

	2018	2017
Deferred tax liabilities		
Depreciation	373,000	418,000
Amortization of goodwill	1,070,000	1,038,000
Amortization of interest rate cap premium	13,000	79,000
Prepaid expenses	110,000	96,000
Net unrealized gain on derivative instruments	68,000	5,000
Other	-	13,000
	1,634,000	1,649,000
Net deferred tax asset	\$ 571,000	\$ 436,000

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.

11. Earnings Per Share

The following sets forth the computation of basic and diluted earnings per common share for 2018 and 2017:

	2018	2017
Net income available to common shareholders, as reported	\$ 6,322,000	\$ 3,478,000
Weighted-average common shares outstanding	3,345,012	3,373,220
Effect of unvested restricted stock grants	-	-
Diluted weighted-average common shares	3,345,012	3,373,220
Basic earnings per common share	\$ 1.89	\$ 1.03
Diluted earnings per common share	\$ 1.89	\$ 1.03

12. 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, 2018 and 2017, the contractual amounts of the Company's financial instruments were as follows:

	Contract Amount	
	2018	2017
Lending-related instruments:		
Home equity lines-of-credit	\$ 22,728,000	\$ 21,173,000
Other lines-of-credit	56,920,000	58,632,000
Credit card arrangements	2,846,000	2,488,000
Letters-of-credit	2,505,000	3,365,000
Derivative financial instruments:		
Notional amounts of interest rate swaps	117,980,000	120,572,000
Notional amounts of interest rate caps	25,000,000	25,000,000

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.

13. 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.

14. 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.

15. 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 will be effective. As of December 31, 2018, the Bank had a capital conservation buffer of 5.40% of risk-weighted assets, which was in excess of the phased-in regulatory requirement of 1.875%. 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%. Management believes, as of December 31, 2018 and 2017, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2018, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

15. Minimum Regulatory Capital Requirements (cont.)

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, 2018 and 2017 are also presented in the table.

As of December 31, 2018	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	\$ 80,498,000	13.4%	\$ 48,065,000	8.0%	\$ 60,082,000	10.0%
Tier 1 Capital to Risk-Weighted Assets Bank	74,609,000	12.4	36,049,000	6.0	48,065,000	8.0
Common Equity Tier 1 Capital to Risk-Weighted Assets Bank	74,609,000	12.4	27,037,000	4.5	39,053,000	6.5
Tier 1 Capital to Average Assets Bank	74,609,000	9.4	31,694,000	4.0	39,617,000	5.0
As of December 31, 2017						
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

16. 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, 2018 and 2017, expense attributable to the plan amounted to \$355,000 and \$330,000, respectively.

The Company has established a non-qualified supplemental executive retirement plan for the benefit of key employees. The amount of each benefit is guaranteed contingent upon employee vesting schedules. As of December 31, 2018 and 2017, the accrued liability of the plan was \$2,662,000 and \$2,391,000, respectively, and is recorded in accrued expenses and other liabilities. The present value of these benefits, being expensed over the employment service period, amounted to \$326,000 and \$309,000 for 2018 and 2017, respectively. Life insurance policies were acquired for the purpose of serving as the primary funding source. The cash value of these policies was \$12,069,000 and \$11,751,000 at December 31, 2018 and 2017, respectively, and is included in other assets.

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 \$700 and \$675 for 2018 and 2017, respectively, 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.

17. 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 2018 or 2017. A total of 11,897 shares have been issued under the restricted stock plan since inception, all of which are vested.

18. 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:

	2018	2017
Legal, audit, examination and consulting	\$ 593,000	\$ 631,000
Printing, postage, stationary and supplies	307,000	355,000
Account servicing	517,000	479,000
Foreclosed asset and account loss	182,000	370,000

19. Related Party Transactions

In the ordinary course of business, the Company has granted loans to principal officers and directors and their affiliates amounting to \$18,989,000 and \$17,678,000 at December 31, 2018 and 2017, respectively. Deposits from related parties held by the Company at December 31, 2018 and 2017 amounted to \$6,894,000 and \$6,444,000, respectively.

20. 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, 2018
October 2016	25,500	\$ 11.25	\$ 287,000	\$ 97,000

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, 2018
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.

Date	Shares	Net Price Per Share	Original Debt	Principal Balance Dec. 31, 2019
June 2018	32,300	\$ 16.38	\$ 529,000	\$ 509,000

The June 2018 loan is from Katahdin Bankshares Corp. and is repayable annually with an interest rate of 5.0% for a term of 9 years and 6 months.

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, 2018 and 2017 totaled \$140,000 and \$97,000, respectively. ESOP expense was \$141,000 and \$87,000 for the years ended December 31, 2018 and 2017, respectively.

As of December 31, 2018, the remaining principal balance of the loans are scheduled to be paid as follows:

2019	\$ 138,000
2020	142,000
2021	143,000
2022	148,000
2023	152,000
2024 and after	254,000
	\$ 977,000

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

20. Employee Stock Ownership Plan (cont.)

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

	2018	2017
Allocated	20,166	9,887
Unallocated	64,634	42,613
	84,800	52,500

The fair value of the unallocated shares as of December 31, 2018 and 2017 was approximately \$1,058,000 and \$676,000, respectively.

21. 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 other 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, 2018 and 2017, Using				
December 31, 2018	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	\$ 1,973,000	\$ -	\$ 1,973,000	\$ -
State and municipal	10,613,000	-	10,613,000	-
Corporate bonds	1,933,000	-	1,933,000	-
Mortgage-backed and CMO's	78,214,000	-	78,214,000	-
Other securities	415,000	415,000	-	-
Total securities available-for-sale	93,148,000	415,000	92,733,000	-
Derivative instruments	2,543,000	-	2,543,000	-
Total assets	\$95,691,000	\$ 415,000	\$95,276,000	\$ -
Liabilities				
Derivative instruments	\$ 2,016,000	\$ -	\$ 2,016,000	\$ -

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	-
Other securities	467,000	467,000	-	-
Total securities available-for-sale	86,872,000	-	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	\$ -

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, 2018 and 2017, Using				
December 31, 2018	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)	\$ 1,239,000	\$ -	\$ 1,239,000	\$ -
Other real estate and property owned (market approach)	16,000	-	16,000	-
December 31, 2017				
Assets				
Impaired loans (market approach)	\$ 2,389,000	\$ -	\$ 2,389,000	\$ -
Other real estate and property owned (market approach)	384,000	-	384,000	-

Certain impaired loans were written down to their value of \$1,239,000 and \$2,389,000 at December 31, 2018 and 2017, respectively, resulting in an impairment charge through the allowance for loan losses.

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

21. Fair Value (cont.)

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 the fair value of the underlying collateral as determined by appraisals of the collateral by third-party appraisers and brokers' opinions by third-party brokers, or the present value of future cash flows. 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:

	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	\$ 5,790,000	\$ 5,790,000	\$ 5,790,000	\$ -	\$ -
Interest bearing deposits in banks	11,586,000	11,586,000	11,586,000	-	-
Securities available-for-sale	93,148,000	93,148,000	415,000	92,733,000	-
Securities held-to-maturity	7,000	7,000	-	7,000	-
FHLB stock	3,164,000	3,164,000	-	3,164,000	-
Loans receivable, net:					
Commercial	166,486,000	166,343,000	-	409,000	165,934,000
Commercial real estate	339,798,000	333,059,000	-	615,000	332,444,000
Residential real estate	138,424,000	132,831,000	-	193,000	132,638,000
Consumer	9,911,000	9,865,000	-	22,000	9,843,000
Loan receivable, net	654,619,000	642,098,000	-	1,239,000	640,859,000
Accrued interest receivable	1,777,000	1,777,000	-	1,777,000	-
Derivative instruments	2,543,000	2,543,000	-	2,543,000	-

	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 liabilities					
Deposits	657,074,000	625,337,000	-	625,337,000	-
Advances from FHLB	58,801,000	58,185,000	-	58,185,000	-
Other borrowed funds	400,000	396,000	-	396,000	-
Accrued interest payable	352,000	352,000	-	352,000	-
Junior subordinated debentures	7,217,000	7,217,000	-	7,217,000	-
Derivative instruments	2,016,000	2,016,000	-	2,016,000	-

Fair Value Measurement at December 31, 2017

Financial assets					
Cash and due from banks	\$ 5,620,000	\$ 5,620,000	\$ 5,620,000	\$ -	\$ -
Interest bearing deposits in banks	8,364,000	8,364,000	8,364,000	-	-
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	-

22. 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.

23. Interest Rate Swaps and Caps

The Company uses derivative instruments as partial hedges against large fluctuations in interest rates. At least quarterly, all financial instruments are reviewed as part of the asset/liability management process. The financial instruments are factored into the Company's overall interest rate risk position. The Company regularly reviews the credit quality of the counterparty from which the instruments have been purchased. The Company uses derivative financial instruments for risk management purposes and not for trading or speculative purposes. The Company controls the credit risk of these instruments through collateral, credit approvals, and monitoring procedures. The derivative instruments contain provisions that require the Company to post collateral with the counterparty for its contracts that are in a net loss position based on their fair value and the Company's credit rating. At December 31, 2018, the Company had posted \$3,000,000 of cash

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018 and 2017

23. Interest Rate Swaps and Caps (cont.)

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,	
						2018	2017
Bank	15,000,000	July 1, 2016	June 30, 2020	1-Month USD LIBOR	0.855%	\$372,000	\$430,000

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,	
						2018	2017
Bank	\$25,000,000	\$1,998,000	April 4, 2019	3-Month USD LIBOR	0.23%	\$155,000	\$529,000

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:

	2018 Asset (Liability)	2017 Asset (Liability)
Swaps receive fixed	\$ 2,016,000	\$ 1,355,000
Swaps pay fixed	(2,016,000)	(1,355,000)
Net customer related swaps	\$ -	\$ -

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

	2018	2017
Swaps receive fixed	\$ 51,490,000	\$ 52,786,000
Swaps pay fixed	(51,490,000)	(52,786,000)

24. 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 1, 2019, 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 6, 2019 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 otcm Markets.com/stock/KTHN/quote.



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 (Broadway and Springer Drive), 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.





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