2017 Annual Report to Shareholders

**NORTHWAY FINANCIAL, INC.**
**2017 ANNUAL REPORT**

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## SELECTED FINANCIAL HIGHLIGHTS

| At or for the years ended December 31, | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| ($000 Omitted, except per share data) | | | | | |
| *Balance Sheet Data:* | | | | | |
| Total assets | $ 884,084 | $ 889,598 | $ 933,604 | $ 925,713 | $ 898,329 |
| Securities available-for-sale, at fair value | 258,109 | 261,008 | 254,476 | 221,647 | 184,527 |
| Loans, net before allowance for loan losses | 572,525 | 553,472 | 555,922 | 603,593 | 642,259 |
| Allowance for loan losses | 7,231 | 7,878 | 8,623 | 8,806 | 11,190 |
| Other real estate owned | 142 | 118 | 463 | 1,138 | 1,581 |
| Goodwill | 9,934 | 9,934 | 9,934 | 9,934 | 9,934 |
| Core deposit intangibles, net | 44 | 82 | 132 | 194 | 267 |
| Deposits | 722,755 | 737,732 | 757,922 | 726,630 | 694,359 |
| Short-term borrowings | 53,380 | 50,528 | 44,042 | 34,850 | 35,465 |
| Long-term debt | 20,620 | 20,620 | 55,527 | 65,434 | 80,796 |
| Shareholders' equity | 81,189 | 74,403 | 70,307 | 90,918 | 82,188 |
| *Income Statement Data:* | | | | | |
| Net interest and dividend income | $ 27,886 | $ 25,911 | $ 27,080 | $ 28,360 | $ 28,049 |
| Provision for loan losses | - | - | - | 1,503 | 2,820 |
| Noninterest income | 8,182 | 8,352 | 7,903 | 10,955 | 11,862 |
| Noninterest expense | 26,342 | 29,302 | 26,018 | 27,535 | 27,377 |
| Net income | 7,278 | 4,015 | 6,485 | 7,853 | 7,206 |
| Net income applicable to common stock | 7,278 | 4,015 | 6,212 | 7,585 | 6,925 |
| *Per Common Share Data: (1)(2)* | | | | | |
| Net income – basic | $ 2.64 | $ 1.46 | $ 2.26 | $ 2.76 | $ 2.57 |
| Net income – assuming dilution | 2.64 | 1.46 | 2.26 | 2.76 | 2.57 |
| Cash dividends declared and paid, common stock | 0.64 | 0.64 | 0.64 | 0.64 | 0.64 |
| Book value | 29.51 | 27.04 | 25.55 | 24.48 | 21.32 |
| Tangible book value | 25.88 | 23.40 | 21.89 | 20.80 | 17.05 |
| *Selected Ratios:* | | | | | |
| Return on average assets | 0.82 % | 0.44 % | 0.69 % | 0.84 % | 0.82 % |
| Return on average shareholders' equity | 9.32 | 5.38 | 7.01 | 8.96 | 8.89 |
| Common stock dividend payout | 24.20 | 43.86 | 28.33 | 23.22 | 24.82 |
| Average shareholders' equity to average assets | 8.82 | 8.23 | 9.86 | 9.40 | 9.20 |

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

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

## NATURE OF OPERATIONS

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

All amounts presented have been rounded to the nearest thousands, except per share amounts.

## FORWARD-LOOKING STATEMENTS

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

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

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

## 2017 OVERVIEW

The Company reported net income of $7,278 in 2017 compared to net income of $4,015 in 2016. In 2017, $7,278, or $2.64 per common share, was available to common shareholders compared to $4,015, or $1.46 per common share, in 2016. Return on average shareholders’ equity was 9.32% in 2017 compared to 5.38% in 2016. Return on average assets was 0.82% in 2017 compared to 0.44% in 2016.

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

During 2017, the Company recorded an increase in net interest and dividend income of $1,975, due primarily to a decrease in the rate paid on interest-bearing liabilities of 20 basis points. During 2017, interest and dividend income increased $413. Average investment security balances increased $20,540 and the yield on investment securities increased 21 basis points resulting in an increase in interest and dividend income on investment securities of $946. Interest and dividend income on cash and cash equivalents decreased $170 as a result of a decrease in average balances of $44,300 partially offset by an increase in yield of 51

basis points. Interest and dividend income on loans decreased $363 as a result of a decrease in the yield of 12 basis points, partially offset by an increase in average balances of $5,452.

Total interest expense decreased $1,562. Interest expense on borrowed funds decreased $530 as a result of a decrease in the average rate paid of 0.67% due primarily to the repayment of $33,000 in FHLBB long-term advances at an average rate of 4.04% during 2016. Interest expense on deposits decreased $1,032 due primarily to a decrease in the average rate paid of 14 basis points as well as a decrease in average balances of $34,950. During 2017, average certificates of deposit balances decreased $59,330 due to a designed effort to reduce excess liquidity through the elimination of high rate single deposit accounts. These funds were at an average rate of 1.13%. These balances were partially replaced with lower costing savings and NOW balances.

Based on the continued improvement of the credit quality of our loan portfolio and other factors relevant to the adequacy of our allowance for loan losses, there was no provision for loan losses for the years ended December 31, 2017 and 2016. The allowance for loan losses as a percentage of nonperforming loans increased to 242% at December 31, 2017 compared to 236% at December 31, 2016. Nonperforming loans as a percentage of total loans decreased to 0.52% as of December 31, 2017 compared to 0.60% as of December 31, 2016.

Noninterest income, excluding net gain on sales of loans and net securities gains, decreased $171 compared to the same period in 2016 primarily due to a decrease partially offset by a $189 improvement in the gain on cash surrender value of life insurance. Net gains on sales of securities were $2,704 in 2017 compared to $2,661 in 2016. Noninterest expense decreased $2,960 in 2017. The decrease was the result of two non-recurring expenses recorded in 2016: 1) in September, the Company incurred $993 of costs in connection with the prepayment of $33,000 in FHLBB advances due to mature in 2017, which was recorded in other noninterest expense; and 2) in December, the Company recognized a $3,077 expense related to the termination of its defined benefit plan in salary and benefits expense. These decreases in noninterest expenses were offset by an increase in salary and employee benefits of $1,406 during 2017.

Total assets decreased $5,514, or 0.6%, to $884,084 at December 31, 2017 compared to $889,598 at December 31, 2016. The following is a summary of notable balance sheet changes.

| | ($000 Omitted) December 31 | | | |
|---|---|---|---|---|
| | | | Change | |
| | 2017 | 2016 | Amount | % |
| Total assets | $ 884,084 | $ 889,598 | $ (5,514) | -0.6 |
| Earning assets | 844,740 | 851,292 | (6,552) | -0.8 |
| Securities available-for-sale, at fair value | 258,109 | 261,008 | (2,899) | -1.1 |
| Interest-bearing deposits | 11,471 | 32,541 | (21,070) | -64.7 |
| Loans, net before allowance for loan loses | 572,525 | 553,472 | 19,053 | 3.4 |
| Total deposits | 722,755 | 737,732 | (14,977) | -2.0 |
| Borrowings | 74,000 | 71,148 | 2,852 | 4.0 |
| Shareholders' equity | 81,189 | 74,403 | 6,786 | 9.1 |

Compared to last year, the decrease in total assets was the result of a reduction in interest-bearing deposits of $21,070 while loans, net before allowance for loan losses increased $19,053. Total deposits decreased $14,977 due primarily to management's decision to not renew maturing higher rate single account customer and institutional certificates of deposit. This resulted in a decrease in interest-bearing time deposits of $46,506 since December 31, 2016. Stockholders' equity increased $6,786 as a result of year-to-date net income of $7,278 and an improvement in other comprehensive income of $1,282 partially offset by the declaration and payment of common stock dividends of $1,761.

## CONSOLIDATED STATEMENTS OF INCOME

| FOR THE YEARS ENDED DECEMBER 31, | ($000 Omitted, except per share data) 2017 | 2016 |
|---|---|---|
| Interest and dividend income | | |
| Interest and fees on loans | $ 23,874 | $ 24,237 |
| Interest on debt securities available-for-sale | | |
| Taxable | 5,216 | 4,526 |
| Tax-exempt | 1,117 | 900 |
| Dividends | 593 | 554 |
| Interest on interest-bearing deposits | 120 | 290 |
| Total interest and dividend income | 30,920 | 30,507 |
| Interest expense | | |
| Interest on deposits | 2,215 | 3,247 |
| Interest on short-term borrowings | 245 | 66 |
| Interest on long-term debt | 574 | 1,283 |
| Total interest expense | 3,034 | 4,596 |
| Net interest and dividend income | 27,886 | 25,911 |
| Provision for loan losses | - | - |
| Net interest and dividend income after provision for loan losses | 27,886 | 25,911 |
| Noninterest income | | |
| Service charges and fees on deposit accounts | 1,677 | 1,756 |
| Debit card fees | 1,598 | 1,514 |
| Gain on sales and calls of securities available-for-sale, net | 2,704 | 2,661 |
| Commission on alternative investments | 486 | 524 |
| Other | 1,717 | 1,897 |
| Total noninterest income | 8,182 | 8,352 |
| Noninterest expense | | |
| Salaries and employee benefits | 16,117 | 17,788 |
| Office occupancy and equipment | 3,644 | 3,434 |
| Amortization of core deposit intangibles | 38 | 50 |
| Other | 6,543 | 8,030 |
| Total noninterest expense | 26,342 | 29,302 |
| Income before income tax expense | 9,726 | 4,961 |
| Income tax expense | 2,448 | 946 |
| Net income | $ 7,278 | $ 4,015 |
| Net income available to common shareholders | $ 7,278 | $ 4,015 |
| Basic earnings per common share | $ 2.64 | $ 1.46 |
| Earnings per common share assuming dilution | $ 2.64 | $ 1.46 |

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| FOR THE YEARS ENDED DECEMBER 31, | ($000 Omitted) 2017 | 2016 |
|---|---|---|
| Net income | $ 7,278 | $ 4,015 |
| Other comprehensive income | | |
| Net unrealized gains on securities available-for-sale | 4,736 | 1,125 |
| Reclassification adjustment for realized gains in net income (1) | (2,704) | (2,661) |
| Net unrealized gains/(losses) on securities | 2,032 | (1,536) |
| Pension valuation adjustment (see Note 14) | - | 3,945 |
| Interest rate swap valuation | 171 | 638 |
| Investment in limited partnership valuation adjustment | 9 | 3 |
| Other comprehensive income | 2,212 | 3,050 |
| Income tax provision | (943) | (1,208) |
| Other comprehensive income, net of tax | 1,269 | 1,842 |
| Comprehensive income | $ 8,547 | $ 5,857 |

(1) Reclassification adjustments include realized gains and losses on available for sale securities. The gains and losses have been reclassified out of other comprehensive income and affect certain captions in the consolidated statements of income as follows; the pre-tax amount is reflected in gain on sales and calls of available-for-sale securities, net; the tax effect is included in income tax expense; and the after tax amount is included in net income.

See Notes to Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEETS

| AS OF DECEMBER 31, | ($000 Omitted, except per share data) 2017 | 2016 |
|---|---|---|
| Assets | | |
| Cash and cash equivalents | | |
| Cash and due from banks and interest-bearing deposits | $ 23,691 | $ 43,204 |
| Total cash and cash equivalents | 23,691 | 43,204 |
| Restricted cash | 1,400 | 1,650 |
| Securities available-for-sale, at fair value | 258,109 | 261,008 |
| Federal Home Loan Bank of Boston stock | 1,421 | 1,398 |
| Loans held-for-sale | 616 | 242 |
| Loans, net before allowance for loan losses | 572,525 | 553,472 |
| Less: allowance for loan losses | 7,231 | 7,878 |
| Net loans | 565,294 | 545,594 |
| Premises and equipment, net | 11,733 | 12,796 |
| Other real estate owned | 142 | 118 |
| Goodwill | 9,934 | 9,934 |
| Core deposit intangibles, net | 44 | 82 |
| Other assets | 11,700 | 13,572 |
| Total assets | $ 884,084 | $ 889,598 |
| Liabilities and Shareholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Demand | $ 132,530 | $ 126,488 |
| Regular savings, NOW and money market deposit accounts | 479,779 | 454,292 |
| Certificates of deposit (in denominations of $250 or more) | 7,291 | 11,923 |
| Other time | 103,155 | 145,029 |
| Total deposits | 722,755 | 737,732 |
| Short-term borrowings | 53,380 | 50,528 |
| Long-term debt | 20,620 | 20,620 |
| Other liabilities | 6,140 | 6,315 |
| Total liabilities | 802,895 | 815,195 |
| Shareholders' equity | | |
| Common stock, $1.00 par value; 9,000 shares authorized; 3,800 shares issued and 2,752 outstanding at December 31, 2017 and December 31, 2016 | 3,800 | 3,800 |
| Additional paid-in-capital | 4,140 | 4,140 |
| Retained earnings | 88,647 | 83,143 |
| Treasury stock, 1,049 shares at December 31, 2017 and December 31, 2016 | (15,470) | (15,470) |
| Accumulated other comprehensive income/(loss), net of tax | 72 | (1,210) |
| Total shareholders' equity | 81,189 | 74,403 |
| Total liabilities and shareholders' equity | $ 884,084 | $ 889,598 |

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

($000 Omitted, except per share data)

| | Common Stock | Additional Paid-in-Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income/(Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|---|
| Balance at December 31, 2015 | $ 3,800 | $ 4,140 | $80,889 | $(15,470) | $ (3,052) | $ 70,307 |
| Net income - 2016 | - | - | 4,015 | - | - | 4,015 |
| Other comprehensive income, net of taxes | - | - | - | - | 1,842 | 1,842 |
| Cash dividends declared on common stock ($0.64 per share) | - | - | (1,761) | - | - | (1,761) |
| Balance at December 31, 2016 | $ 3,800 | $ 4,140 | $83,143 | $(15,470) | $ (1,210) | $ 74,403 |
| Net income - 2017 | - | - | 7,278 | - | - | 7,278 |
| Other comprehensive income, net of tax | - | - | - | - | 1,269 | 1,269 |
| Reclassfication adjustment for stranded accumulated other comprehensive income due to tax rate change | - | - | (13) | | 13 | - |
| Cash dividends declared on common stock ($0.64 per share) | - | - | (1,761) | - | - | (1,761) |
| Balance at December 31, 2017 | $ 3,800 | $ 4,140 | $88,647 | $(15,470) | $ 72 | $ 81,189 |

At December 31, accumulated other comprehensive income/(loss), net of tax, consists of the following:

| ($000 Omitted) | 2017 | 2016 |
|---|---|---|
| Net unrealized holding losses on available-for-sale securities | $ (439) | $ (1,588) |
| Net loss on investment in a limited partnership | - | (7) |
| Net unrealized gain on interest rate swaps | 511 | 385 |
| | $ 72 | $ (1,210) |

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| FOR THE YEARS ENDED DECEMBER 31, | ($000 Omitted) 2017 | 2016 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 7,278 | $ 4,015 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,276 | 1,304 |
| Deferred income tax expense/(benefit) | 137 | (228) |
| Pension plan termination loss | - | 3,077 |
| Gain on sales and calls of securities available-for-sale, net | (2,704) | (2,661) |
| Write-down of other real estate owned | - | 42 |
| Loss on disposal and write-down of premises and equipment | 464 | 43 |
| Amortization of premiums and accretion of discounts on securities available-for-sale, net | 1,075 | 1,295 |
| Amortization of deferred prepayment penalty on FHLBB advances | - | 93 |
| Change in unearned income/unamortized cost, net | (199) | (15) |
| Loss on investment in limited partnership | 24 | - |
| Gain on sale of premises and equipment | (316) | - |
| Gain on sales of other real estate owned and other chattels, net | (96) | (5) |
| Net (increase)/decrease in loans held-for-sale | (374) | 7 |
| Net change in other assets and other liabilities | 543 | 592 |
| Net cash provided by operating activities | 7,108 | 7,559 |
| Cash flows from investing activities: | | |
| Proceeds from sales of securities available-for-sale | 25,633 | 70,933 |
| Proceeds from maturities and calls of securities available-for-sale | 28,369 | 50,499 |
| Purchase of securities available-for-sale | (47,442) | (128,134) |
| Purchase of FHLBB stock | (3,159) | - |
| Redemption of FHLBB stock | 3,136 | 1,760 |
| Redemption of interest-bearing time deposits | - | 248 |
| Loan originations and principal collections, net | (14,752) | 8,354 |
| Purchase of loans, net of principal collections | (5,200) | (7,009) |
| Recoveries of previously charged-off loans | 309 | 329 |
| Proceeds from sale of premises and equipment | 367 | - |
| Proceeds from sales of and payments received on other real estate owned | 214 | 405 |
| Additions to premises and equipment and software, net of disposals | (460) | (1,100) |
| Net cash used by investing activities | (12,985) | (3,715) |
| Cash flows from financing activities: | | |
| Net decrease in deposits | (14,977) | (20,190) |
| Net increase in short-term borrowings | 2,852 | 6,486 |
| Repayment of FHLBB advances | - | (35,000) |
| Cash dividends paid | (1,761) | (1,761) |
| Net decrease /(increase) in restricted cash received for interest rate swap collateral | 250 | (1,650) |
| Cash paid for pension plan termination | - | (4) |
| Net cash used by financing activities | (13,636) | (52,119) |
| Net decrease in cash and cash equivalents | (19,513) | (48,275) |
| Cash and cash equivalents at beginning of year | 43,204 | 91,479 |
| Cash and cash equivalents at end of year | $ 23,691 | $ 43,204 |

## CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

| FOR THE YEARS ENDED DECEMBER 31, | ($000 Omitted) 2017 | 2016 |
|---|---|---|
| Supplemental disclosure of cash flow information: | | |
| Interest paid | $ 3,077 | $ 4,755 |
| Taxes paid | 1,481 | 1,011 |
| Non-cash investing and financing activities: | | |
| Loans transferred to other real estate owned | 142 | 177 |
| Reclassification adjustment for stranded accumulated other comprehensive income due to tax rate change | 13 | - |

See Notes to Consolidated Financial Statements

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### *Nature of Operations*

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

### *Basis of Presentation*

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

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

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

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

### *Reclassifications*

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

### *Cash and Cash Equivalents*

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

### *Restricted Cash*

The Company holds restricted cash as collateral for interest rate swaps. See Note 17 "On-Balance Sheet Derivative Instruments and Hedging Activities."

### *Securities*

Securities are classified as available-for-sale and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity, net of estimated income taxes.

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

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

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

Federal Home Loan Bank of Boston ("FHLBB") stock is carried at cost and can only be sold to the FHLBB based on its current redemption policies. Management evaluates the Company's investment in FHLBB stock for other-than-temporary impairment at least on a quarterly basis and more frequently when economic or market conditions warrant such calculations. Based on its most recent analysis of the FHLBB as of December 31, 2017, management deems its investment in FHLBB stock to be not other-than-temporarily impaired.

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

### *Loans Held-for-Sale*

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

### *Loans*

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

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

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

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

### *Allowance for Loan Losses*

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

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

General component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following loan segments: residential real estate, residential construction, commercial real estate, commercial real estate construction, commercial, municipal and consumer. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following

qualitative factors: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company's policies pertaining to the general component of the allowance for loan losses during 2017. During 2016, the pooling of loans methodology was modified to align with the Call Report codes and to follow industry best practices. Due to the 0% historical loss trend in several of the pools, the Company implemented a loss floor of 50 basis points for commercial loan pools and a floor of 25 basis points for all other pools. Our qualitative factors continue to be reviewed quarterly.

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

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

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

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

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

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

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

Allocated component

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

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls

generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

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

Unallocated component

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

### *Premises and Equipment*

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

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

### *Other Real Estate Owned*

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

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

### *Advertising*

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

### *Income Taxes*

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

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

### *Earnings Per Share*

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

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

| | Years Ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Net income | $ 7,278 | $ 4,015 |
| Net income available to common shareholders | $ 7,278 | $ 4,015 |
| Average number of common shares outstanding | 2,751.7 | 2,751.7 |
| Effect of dilutive options | - | - |
| Average number of common shares outstanding used to calculate diluted earnings per common share | 2,751.7 | 2,751.7 |

### *Derivative Financial Instruments*

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

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

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

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

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

### Recent Accounting Pronouncements

In May 2014 and August 2015, respectively, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09 and 2015-14, "Revenue from Contracts with Customers (Topic 606)". The objective of ASU 2014-09 is to clarify principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards. The guidance in ASU 2014-09 affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principal of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company has reviewed ASUs 2014-09 and 2015-14 and determined that they will not have a material impact on its consolidated financial statements, as the Company's revenue is comprised substantially of net interest income on financial assets and liabilities, and the impact on noninterest income is not material.

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

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

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

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

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

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

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

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

The amendments in this Update are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early application of certain of the pending content is permitted for financial statements of fiscal years or interim periods that have not yet been issued. The Company is currently reviewing this ASU to determine the impact it will have on its consolidated financial statements. As of December 31, 2017, the Company held $1,056 of unrealized gains, net of unrealized losses, on equity investments. Refer to Note 2, "Securities Available-for-Sale", for information pertaining to equity securities held by the Company as of the periods presented.

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

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

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

## NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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

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

This update is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early application is permitted, including adoption in an interim period. The Company determined adoption of this guidance will not have a material impact on its consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230)". These amendments require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. As a result, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The amendments do not provide a definition of restricted cash or restricted cash equivalents. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The amendments should be applied using a retrospective transition method to each period presented. The Company does not anticipate the impact to be significant.

In March 2017, the FASB issued ASU 2017-08, "Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities". The amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The update is effective for years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted with any adjustments reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is currently reviewing this ASU to determine if it will have an impact on its consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities". These amendments refine and expand hedge accounting for both financial and commodity risks. The financial risks include interest rate risks. The provisions create more transparency around how economic results are presented, both on the face of the financial statements and in the footnotes. It also makes certain targeted improvements to simplify the application of hedge accounting guidance. The update is effective for years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption, including adoption in an interim period, is permitted. Any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The Company is currently reviewing this ASU to determine if it will have an impact on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, "Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (AOCI)". The update allows the option to reclassify stranded tax effects within AOCI to Retained Earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendment is effective for the Company for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption, including application to financial statements not yet issued or available to be issued, is permitted. The Company early-adopted this ASU effective with its 2017 consolidated financial statements, and for which there was no material impact.

## NOTE 2 SECURITIES AVAILABLE-FOR-SALE

The amortized cost basis, gross unrealized gains, gross unrealized losses, and fair value of securities at December 31, 2017 and 2016 follow:

| | Amortized Cost Basis | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| December 31, 2017 | | | | |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 42,475 | $ 23 | $ 547 | $ 41,951 |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 96,598 | 69 | 1,124 | 95,543 |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 46,264 | 24 | 350 | 45,938 |
| State and political subdivision bonds | 57,720 | 802 | 551 | 57,971 |
| Marketable equity securities | 15,650 | 1,563 | 507 | 16,706 |
| | $ 258,707 | $ 2,481 | $ 3,079 | $ 258,109 |
| December 31, 2016 | | | | |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 27,478 | $ 23 | $ 406 | $ 27,095 |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 109,404 | 25 | 1,465 | 107,964 |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 52,191 | 297 | 296 | 52,192 |
| State and political subdivision bonds | 55,798 | 211 | 1,629 | 54,380 |
| Marketable equity securities | 18,767 | 1,424 | 814 | 19,377 |
| | $ 263,638 | $ 1,980 | $ 4,610 | $ 261,008 |

The contractual maturity distribution of investments in debt obligations at December 31, 2017 follows:

| | Within One Year | Over One Through Five Years | After Five Through Ten Years | Over Ten Years | Total Amortized Cost |
|---|---|---|---|---|---|
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ - | $ - | $ 12,975 | $ 29,500 | $ 42,475 |
| U.S. government agency and sponsored enterprise mortgage-backed securities | - | 321 | 1,653 | 94,624 | 96,598 |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | - | 3,821 | 664 | 41,779 | 46,264 |
| State and political subdivision bonds | - | - | 1,936 | 55,784 | 57,720 |
| Total amortized cost | $ - | $ 4,142 | $ 17,228 | $ 221,687 | $ 243,057 |
| Fair value | $ - | $ 4,115 | $ 17,030 | $ 220,258 | $ 241,403 |

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

For the years ended December 31, 2017 and 2016, gross proceeds from the sales of securities available-for-sale amounted to $25,633 and $70,933, respectively. An analysis of gross realized gains and losses on sales of securities available-for-sale during the years ended December 31, follows:

## NOTE 2 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Realized Gains | Realized Losses | Realized Gains | Realized Losses |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ - | $ - | $ 539 | $ - |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 135 | - | 891 | - |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | - | - | - | - |
| State and political subdivision bonds | 14 | 4 | 375 | - |
| Marketable equity securities | 2,778 | 221 | 1,036 | 233 |
| | $ 2,927 | $ 225 | $ 2,841 | $ 233 |

The tax provision applicable to these net realized gains amounted to $1,071 and $1,033 for 2017 and 2016, respectively.

Securities with a carrying amount totaling $217,413 and $199,583 were pledged to secure public deposits and securities sold under agreements to repurchase at December 31, 2017 and 2016, respectively.

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

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| December 31, 2017 | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 19,687 | $ 314 | $ 7,242 | $ 233 | $ 26,929 | $ 547 |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 37,395 | 373 | 38,851 | 751 | 76,246 | 1,124 |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 21,964 | 135 | 11,902 | 215 | 33,866 | 350 |
| State and political subdivision bonds | 850 | 4 | 18,125 | 547 | 18,975 | 551 |
| Marketable equity securities | 1,143 | 251 | 3,300 | 256 | 4,443 | 507 |
| Total temporarily impaired securities | $ 81,039 | $ 1,077 | $ 79,420 | $ 2,002 | $ 160,459 | $ 3,079 |
| | | | | | | |
| December 31, 2016 | | | | | | |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 22,071 | $ 406 | $ - | $ - | $ 22,071 | $ 406 |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 102,270 | 1,465 | - | - | 102,270 | 1,465 |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 28,710 | 296 | - | - | 28,710 | 296 |
| State and political subdivision bonds | 35,983 | 1,616 | 531 | 13 | 36,514 | 1,629 |
| Marketable equity securities | 4,750 | 311 | 2,932 | 503 | 7,682 | 814 |
| Total temporarily impaired securities | $ 193,784 | $ 4,094 | $ 3,463 | $ 516 | $ 197,247 | $ 4,610 |

At December 31, 2017, securities with a total fair value of $160,459 were in a loss position. These securities included six U.S. government agency securities with a fair value of $26,929 and an unrealized loss of $547 at December 31, 2017. These securities had an unrealized loss due to the current interest rate environment. As these securities are guaranteed by Federal Farm Credit Bank ("FFCB"), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal National Mortgage Association ("FNMA"), there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Thirty-one U.S. government agency and sponsored enterprise mortgage-backed securities with a fair value of $76,246 had an unrealized loss of $1,124 at December 31, 2017. These securities had a loss due to the current interest rate environment. As these securities are guaranteed by U.S. government agencies or government-sponsored enterprises such as the FHLMC, FNMA or the

## NOTE 2 SECURITIES AVAILABLE-FOR-SALE (CONTINUED)

Government National Mortgage Association, there is minimal credit risk associated with them. These securities are not other-than-temporarily impaired as the Company has the ability and the intent to hold these securities until cost recovery.

Fifteen collateralized mortgage obligations with a fair value of $33,866 had an unrealized loss of $350 at December 31, 2017. These securities had an unrealized loss due to the current interest rate environment. As these collateralized mortgage obligations are government-sponsored enterprise bonds issued by the Small Business Investment Conduit, the Small Business Administration Participation Certificates, or FNMA there is little or no credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability and intent to hold them until cost recovery.

Twenty-nine state and political subdivision securities with a fair value of $18,975 had an unrealized loss of $551 at December 31, 2017. All of these state and political subdivision securities are guaranteed by municipalities and there is minimal credit risk associated with them. These securities have been classified as not other-than-temporarily impaired as the Company has the ability and intent to hold them until cost recovery.

Thirty-five marketable equity securities with a fair value of $4,443 had an unrealized loss of $507 at December 31, 2017. Marketable equity securities are subject to internal testing on a quarterly basis to determine impairment. Testing includes review of industry analyst reports, credit ratings, sector analysis and earnings projections. Based upon the December 31, 2017 review, these securities have been classified as not other-than-temporarily impaired.

## NOTE 3 LOANS

Loan balances were comprised of the following:

| December 31, | 2017 | 2016 |
|---|---|---|
| Real estate: | | |
| Residential | $ 213,509 | $ 208,080 |
| Commercial | 244,771 | 234,941 |
| Construction | 3,866 | 5,394 |
| Commercial | 64,363 | 62,412 |
| Consumer | 8,368 | 8,182 |
| Municipal | 37,289 | 34,303 |
| Total loans | 572,166 | 553,312 |
| Unamortized costs | 359 | 160 |
| Allowance for loan losses | (7,231) | (7,878) |
| Total unamortized costs and allowance for loan losses | (6,872) | (7,718) |
| Net loans | $ 565,294 | $ 545,594 |

Loans are made in the ordinary course of business to directors, executive officers, and their immediate families and to organizations in which such persons have more than a 10% ownership interest. These loans are made on substantially the same terms, including interest rate and collateral, as those prevailing at the same time for comparable transactions with unrelated persons and did not involve more than the normal risk of collectability or present other unfavorable features. There were no such loans as of December 31, 2017. During 2017, one line of credit was advanced for $30, which was repaid in full during the year.

The Company's lending activities are conducted principally in New Hampshire. Although the loan portfolio is diversified, a portion of its debtors' ability to repay is dependent upon the economic conditions prevailing in New Hampshire. The Company maintains significant credit relationships with borrowers in the hospitality industry. The aggregate loan balances to these industries totaled $78,606 and $64,430 at December 31, 2017 and 2016, respectively.

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans total $67,802 and $72,469 at December 31, 2017 and 2016, respectively. In 2017, $66,598 was commercial loans and $1,204 was residential mortgage loans. For 2016, $71,230 was commercial loans and $1,239 as residential mortgage loans. The Company sold $3,099 of residential mortgage loans in 2017 and $4,798 of residential mortgage loans in 2016.

There were no loans 90 days or more past due and still accruing interest at December 31, 2017 and 2016. The following tables are an aging analysis of the recorded investment in past due loans and nonaccrual loans as of December 31, 2017 and 2016.

## NOTE 3 LOANS (CONTINUED)

Aging Analysis of Past Due Loans

| December 31, 2017 | 30–59 Days | 60–89 Days | 90 Days or More | Total Past Due | Nonaccrual Loans |
|---|---|---|---|---|---|
| Real estate: | | | | | |
| Residential | $ 230 | $ 856 | $ 535 | $ 1,621 | $ 1,920 |
| Commercial | 108 | - | 294 | 402 | 668 |
| Construction | - | 20 | - | 20 | - |
| Commercial | 10 | 11 | 69 | 90 | 358 |
| Consumer | 28 | 20 | 34 | 82 | 45 |
| Total | $ 376 | $ 907 | $ 932 | $ 2,215 | $ 2,991 |

| December 31, 2016 | 30–59 Days | 60–89 Days | 90 Days or More | Total Past Due | Nonaccrual Loans |
|---|---|---|---|---|---|
| Real estate: | | | | | |
| Residential | $ 735 | $ 194 | $ 665 | $ 1,594 | $ 1,448 |
| Commercial | 130 | 266 | 355 | 751 | 1,431 |
| Construction | - | - | - | - | - |
| Commercial | 169 | - | 93 | 262 | 436 |
| Consumer | 41 | 25 | 9 | 75 | 23 |
| Total | $ 1,075 | $ 485 | $ 1,122 | $ 2,682 | $ 3,338 |

| December 31, 2017 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Real estate: | | | | | |
| Residential | $ 1,417 | $ 1,616 | $ - | $ 1,363 | $ 38 |
| Commercial | 676 | 1,275 | - | 3,128 | 23 |
| Construction | 736 | 736 | - | 745 | 44 |
| Commercial | 599 | 737 | - | 802 | 41 |
| Consumer | - | - | - | 6 | - |
| Total impaired with no related allowance | $ 3,428 | $ 4,364 | $ - | $ 6,044 | $ 146 |
| With an allowance recorded: | | | | | |
| Real estate: | | | | | |
| Residential | $ 62 | $ 136 | $ 3 | $ 96 | $ - |
| Commercial | 926 | 926 | 59 | 847 | 39 |
| Commercial | 622 | 622 | 24 | 642 | 18 |
| Consumer | 16 | 16 | 16 | 8 | - |
| Total impaired with an allowance recorded | $ 1,626 | $ 1,700 | $ 102 | $ 1,593 | $ 57 |
| Total: | | | | | |
| Real estate: | | | | | |
| Residential | $ 1,479 | $ 1,752 | $ 3 | $ 1,459 | $ 38 |
| Commercial | 1,602 | 2,201 | 59 | 3,975 | 62 |
| Construction | 736 | 736 | - | 745 | 44 |
| Commercial | 1,221 | 1,359 | 24 | 1,444 | 59 |
| Consumer | 16 | 16 | 16 | 14 | - |
| Total impaired loans | $ 5,054 | $ 6,064 | $ 102 | $ 7,637 | $ 203 |

## NOTE 3 LOANS (CONTINUED)

| December 31, 2016 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Real estate: | | | | | |
| Residential | $ 1,321 | $ 1,388 | $ - | $ 1,438 | $ 16 |
| Commercial | 953 | 1,431 | - | 3,105 | 49 |
| Construction | 736 | 736 | - | 746 | - |
| Commercial | 296 | 387 | - | 676 | 16 |
| Consumer | - | - | - | 11 | - |
| Total impaired with no related allowance | $ 3,306 | $ 3,942 | $ - | $ 5,976 | $ 81 |
| With an allowance recorded: | | | | | |
| Real estate: | | | | | |
| Residential | $ 178 | $ 178 | $ 6 | $ 43 | $ 7 |
| Commercial | 2,232 | 2,321 | 344 | 2,472 | 18 |
| Construction | - | - | - | - | - |
| Commercial | 1,188 | 1,189 | 134 | 789 | 10 |
| Consumer | 17 | 19 | 13 | 6 | 1 |
| Total impaired with an allowance recorded | $ 3,615 | $ 3,707 | $ 497 | $ 3,310 | $ 36 |
| Total: | | | | | |
| Real estate: | | | | | |
| Residential | $ 1,499 | $ 1,566 | $ 6 | $ 1,481 | $ 23 |
| Commercial | 3,185 | 3,752 | 344 | 5,577 | 67 |
| Construction | 736 | 736 | - | 746 | - |
| Commercial | 1,484 | 1,576 | 134 | 1,465 | 26 |
| Consumer | 17 | 19 | 13 | 17 | 1 |
| Total impaired loans | $ 6,921 | $ 7,649 | $ 497 | $ 9,286 | $ 117 |

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

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

| 2017 | | | | Terms of Modification | | |
|---|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post Modification Outstanding Recorded Investment | Extended Maturity | Adjusted Interest Rate | Combination of Rate and Maturity |
| Troubled debt restructurings: | | | | | | |
| Commercial | 1 | $ 100 | $ 100 | $ - | $ - | $ 100 |
| | 1 | $ 100 | $ 100 | $ - | $ - | $ 100 |

| 2016 | | | | Terms of Modification | | |
|---|---|---|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post Modification Outstanding Recorded Investment | Extended Maturity | Adjusted Interest Rate | Combination of Rate and Maturity |
| Troubled debt restructurings: | | | | | | |
| Real estate: | | | | | | |
| Residential | 1 | $ 13 | $ 18 | $ - | $ - | $ 18 |
| Commercial | 7 | 1,230 | 1,234 | - | - | 1,234 |
| Commercial | 6 | 650 | 651 | 601 | - | 50 |
| | 14 | $ 1,893 | $ 1,903 | $ 601 | $ - | $ 1,302 |

## NOTE 3 LOANS (CONTINUED)

There were nine and one TDRs during the fiscal year ended December 31, 2017 and 2016, respectively, with a payment default which occurred within the twelve months following the date of the restructuring. During 2017, four relationships representing six TDR loans totaling $506 were paid net of $252 in charge-offs. During 2016, four TDR loans totaling $126 were fully charged-off. TDRs are individually evaluated for impairment. A specific allowance of $54 and $386 was established for TDR loans for the years ended December 31, 2017 and 2016, respectively. There were no commitments to lend additional funds to borrowers whose loans were modified in a troubled debt restructuring, as of December 31, 2017 and 2016.

## NOTE 4 ALLOWANCE FOR LOAN LOSSES

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

| | Real Estate | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Residential | Commercial | Construction | Commercial | Consumer | Municipal | Unallocated | Total |
| **December 31, 2017** | | | | | | | | |
| Allowance for loans losses: | | | | | | | | |
| Beginning balance | $ 1,752 | $ 3,043 | $ 42 | $ 1,233 | $ 390 | $ 338 | $ 1,080 | $ 7,878 |
| Charge-offs | (168) | (480) | - | (83) | (225) | - | - | (956) |
| Recoveries | 131 | 44 | 5 | 56 | 73 | - | - | 309 |
| Provision (benefit) | 285 | (4) | (16) | (357) | 112 | 18 | (38) | - |
| Ending balance | $ 2,000 | $ 2,603 | $ 31 | $ 849 | $ 350 | $ 356 | $ 1,042 | $ 7,231 |
| Ending balance: individually evaluated for impairment | $ 3 | $ 59 | $ - | $ 24 | $ 16 | $ - | $ - | $ 102 |
| Ending balance: collectively evaluated for impairment | $ 1,997 | $ 2,544 | $ 31 | $ 825 | $ 334 | $ 356 | $ 1,042 | $ 7,129 |
| Loans: | | | | | | | | |
| Ending balance | $ 213,509 | $ 244,771 | $ 3,866 | $ 64,363 | $ 8,368 | $ 37,289 | $ - | $ 572,166 |
| Ending balance: individually evaluated for impairment | $ 1,479 | $ 1,602 | $ 736 | $ 1,221 | $ 16 | $ - | $ - | $ 5,054 |
| Ending balance: collectively evaluated for impairment | $ 212,030 | $ 243,169 | $ 3,130 | $ 63,142 | $ 8,352 | $ 37,289 | $ - | $ 567,112 |
| **December 31, 2016** | | | | | | | | |
| Allowance for loans losses: | | | | | | | | |
| Beginning balance | $ 1,361 | $ 3,133 | $ 171 | $ 2,216 | $ 346 | $ 205 | $ 1,191 | $ 8,623 |
| Charge-offs | (452) | (177) | - | (175) | (270) | - | - | (1,074) |
| Recoveries | 1 | 38 | - | 197 | 93 | - | - | 329 |
| Provision (benefit) | 842 | 49 | (129) | (1,005) | 221 | 133 | (111) | - |
| Ending balance | $ 1,752 | $ 3,043 | $ 42 | $ 1,233 | $ 390 | $ 338 | $ 1,080 | $ 7,878 |
| Ending balance: individually evaluated for impairment | $ 6 | $ 344 | $ - | $ 134 | $ 13 | $ - | $ - | $ 497 |
| Ending balance: collectively evaluated for impairment | $ 1,746 | $ 2,699 | $ 42 | $ 1,099 | $ 377 | $ 338 | $ 1,080 | $ 7,381 |
| Loans: | | | | | | | | |
| Ending balance | $ 208,080 | $ 234,941 | $ 5,394 | $ 62,412 | $ 8,182 | $ 34,303 | $ - | $ 553,312 |
| Ending balance: individually evaluated for impairment | $ 1,499 | $ 3,185 | $ 736 | $ 1,484 | $ 17 | $ - | $ - | $ 6,921 |
| Ending balance: collectively evaluated for impairment | $ 206,581 | $ 231,756 | $ 4,658 | $ 60,928 | $ 8,165 | $ 34,303 | $ - | $ 546,391 |

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

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

## NOTE 4 ALLOWANCE FOR LOAN LOSSES (CONTINUED)

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial real estate, commercial construction and commercial relationships over $500. Annually, the Company engages an independent third-party loan review consulting firm to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its annual review process.

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

| | Real Estate | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential | Commercial | Construction | Commercial | Consumer | Municipal | Total |
| December 31, 2017 | | | | | | | |
| Grade: | | | | | | | |
| Pass | $ 170,115 | $ 226,803 | $ 3,110 | $ 56,587 | $ 4 | $ 59 | $ 456,678 |
| Special mention | 4,107 | 13,195 | 20 | 2,892 | 47 | - | 20,261 |
| Substandard | 1,323 | 4,773 | 736 | 4,858 | 10 | - | 11,700 |
| Doubtful | 162 | - | - | 26 | 10 | - | 198 |
| Loss | - | - | - | - | - | - | - |
| Loans not formally rated | 37,802 | - | - | - | 8,297 | 37,230 | 83,329 |
| Total | $ 213,509 | $ 244,771 | $ 3,866 | $ 64,363 | $ 8,368 | $ 37,289 | $ 572,166 |
| December 31, 2016 | | | | | | | |
| Grade: | | | | | | | |
| Pass | $ 166,003 | $ 212,746 | $ 4,658 | $ 54,711 | $ 3 | $ 259 | $ 438,380 |
| Special mention | 1,144 | 16,717 | - | 2,726 | - | - | 20,587 |
| Substandard | 1,472 | 5,444 | 736 | 4,932 | 1 | - | 12,585 |
| Doubtful | 159 | 34 | - | 43 | 18 | - | 254 |
| Loss | - | - | - | - | - | - | - |
| Loans not formally rated | 39,302 | - | - | - | 8,160 | 34,044 | 81,506 |
| Total | $ 208,080 | $ 234,941 | $ 5,394 | $ 62,412 | $ 8,182 | $ 34,303 | $ 553,312 |

## NOTE 5 PREMISES AND EQUIPMENT

A summary of premises and equipment follows:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Land | $ 5,059 | $ 5,336 |
| Buildings | 12,009 | 12,201 |
| Leasehold improvements | 959 | 959 |
| Equipment | 6,828 | 7,618 |
| | 24,855 | 26,114 |
| Less accumulated depreciation and amortization | 13,122 | 13,318 |
| | $ 11,733 | $ 12,796 |

Depreciation expense for the years ended December 31, 2017 and 2016 amounted to $1,008 and $1,045, respectively.

## NOTE 6 OTHER REAL ESTATE OWNED

Other real estate owned consists of real estate acquired by foreclosure or a similar conveyance of title, as well as former banking premises for which banking use is no longer contemplated. At December 31, 2017, other real estate owned of $142 was comprised of residential real estate of $117 and commercial real estate of $25. At December 31, 2016, other real estate owned of $118 was comprised of former banking premises of $87, and residential real estate of $31. At December 31, 2017 and 2016, the recorded

investment in residential real estate loans in the process of foreclosure totaled $444 and $402, respectively. There were no assets held as other real estate owned in substance as of December 31, 2017 and 2016.

Sales of other real estate owned by the Company resulted in gains of $96 and $5 for the years ended December 31, 2017 and 2016, respectively. Write-downs of other real estate owned by the Company were $0 and $42 for the years ended December 31, 2017 and 2016, respectively.

## NOTE 7 DEPOSITS

The aggregate amount of maturities for time deposits as of December 31, 2017 by year is as follows:

| | | |
|---|---|---|
| 2018 | $ | 54,030 |
| 2019 | | 27,519 |
| 2020 | | 17,790 |
| 2021 | | 6,587 |
| 2022 | | 4,362 |
| Thereafter | | 158 |
| | $ | 110,446 |

At December 31, 2017 and 2016, deposits acquired through a deposit listing service totaled $4,472 and $8,977, respectively. Deposit listing service account balances at or in excess of $250 are reported as certificates of deposit in denominations of $250 or more on the consolidated balance sheets.

Deposits from related parties held by the Bank at December 31, 2017 and 2016 amounted to $4,100 and $3,684, respectively.

## NOTE 8 SHORT-TERM BORROWINGS

Short-term borrowings at December 31, 2017 and 2016 consisted of securities sold under agreements to repurchase of $53,380 and $50,528, respectively. All securities sold under agreements to repurchase are with deposit customers of the Company. Securities sold under agreements to repurchase were at a weighted average rate of 0.24% and 0.16% at December 31, 2017 and 2016, respectively. The securities sold under agreements to repurchase as of December 31, 2017 and 2016 are securities sold on a short-term basis by the Company that have been accounted for not as sales but as borrowings. The underlying securities associated with securities sold under agreements to repurchase are under the control of the Company. The purchasers have agreed to sell to the Company substantially identical securities at the maturity of the agreements.

## NOTE 9 LONG-TERM DEBT

Long-term debt at December 31, 2017 and 2016 consisted of $20,620 of junior subordinated debentures due in year 2037.

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

On March 22, 2007, the Company completed the private placement of $10,310 aggregate liquidation amount of floating rate trust-preferred securities (the “Trust III Capital Securities”) issued by Northway Capital Trust III (“Capital Trust III”). The Trust III Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust III Capital Securities, which included the proceeds from the sale by Capital Trust III of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the “Trust III Junior Subordinated Debt”), which were issued pursuant to an Indenture, dated March 22, 2007 between the Company and Wilmington Trust Company as Trustee. Both the Trust III Capital Securities and the Trust III Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.60%. Currently, the interest rate on these securities is 3.19%. Payments of distributions and other amounts due on the Trust III Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust III has funds available for the payments of such distributions, pursuant to a Guarantee Agreement, dated March 22, 2007, between the Company and Wilmington Trust Company, as Guarantee Trustee. The Trust III Junior Subordinated Debt and the Trust III Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on March 15, 2012.

On June 15, 2007, the Company completed the private placement of $10,310 aggregate liquidation amount of floating rate trust-preferred securities (the “Trust IV Capital Securities”) issued by Northway Capital IV (“Capital Trust IV”). The Trust IV Capital Securities were sold to a pooled investment vehicle. The proceeds from the sale of the Trust IV Capital Securities, which included

## NOTE 9 LONG-TERM DEBT (CONTINUED)

the proceeds from the sale by the Capital Trust IV of its common securities to the Company, were invested in floating rate junior subordinated debt securities of the Company due June 15, 2037 (the "Trust IV Junior Subordinated Debt"), which were issued pursuant to an Indenture, dated June 15, 2007 between the Company and Wells Fargo Bank, National Association, as Trustee.

Both the Trust IV Capital Securities and the Trust IV Junior Subordinated Debt have a floating rate, which resets quarterly, equal to the three-month LIBOR plus 1.49%. Currently, the interest rate on these securities is 3.08%. Payments of distributions and other amounts due on the Trust IV Capital Securities are irrevocably guaranteed by the Company, to the extent that the Capital Trust IV has funds available from the payments of such distributions, pursuant to a Guarantee Agreement, dated June 15, 2007, between the Company and Wells Fargo Bank, National Association, as Guarantee Trustee. The Trust IV Junior Subordinated Debt and the Trust IV Capital Securities may be redeemed at the option of the Company on fixed quarterly dates starting on June 15, 2012.

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

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

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

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

## NOTE 10 GOODWILL AND OTHER INTANGIBLE ASSETS

At December 31, 2017, the Company has goodwill and core deposit intangibles totaling $9,978. Core deposit intangibles are being amortized over their estimated useful lives, and both core deposit intangibles and goodwill are tested for impairment at least annually.

The changes in the carrying amount of goodwill and core deposit intangibles for the years ended December 31, 2017 and 2016 are as follows:

| | Goodwill | Core Deposit Intangibles |
|---|---|---|
| Balance, December 31, 2015 | $ 9,934 | $ 132 |
| Amortization expense | - | (50) |
| Balance, December 31, 2016 | 9,934 | 82 |
| Amortization expense | - | (38) |
| Balance, December 31, 2017 | $ 9,934 | $ 44 |

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

| | |
|---|---|
| 2018 | $ 26 |
| 2019 | 15 |
| 2020 | 3 |

The following table reflects the gross carrying amount and accumulated amortization of core deposit intangibles as of December 31, 2017:

| | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
|---|---|---|---|
| Core deposit intangibles | $ 3,927 | $ 3,883 | $ 44 |

Management reviews the carrying amount of intangible assets on an ongoing basis, taking into consideration any events and circumstances that may indicate the carrying value may not be recoverable. During 2017 and 2016, the Company reviewed the carrying amount of intangible assets and determined that no impairment write-down was required.

## NOTE 11 REGULATORY MATTERS

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

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

Management believes, as of December 31, 2017, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2017, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1 and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the institution's category.

On January 1, 2016, the Company and the Bank became subject to the "capital conservation buffer" requirement, which is being phased in over three years, increasing each year until fully implemented at 2.5% on January 1, 2019. The requirement would limit capital distributions and certain discretionary bonus payments to management if the institution does not hold a "capital conservation buffer" consisting of 2.5% in addition to the minimum capital requirements. At December 31, 2017, the Company and the Bank exceeded the fully phased in regulatory requirement for the "capital conservation buffer."

## NOTE 11 REGULATORY MATTERS (CONTINUED)

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

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2017: | | | | | | |
| Total Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 100,326 | 16.66 % | $ 48,180 | 8.00 % | N/A | N/A |
| Northway Bank | 97,769 | 16.38 | 47,751 | 8.00 | $ 59,688 | 10.00 % |
| Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | 92,466 | 15.35 | 36,135 | 6.00 | N/A | N/A |
| Northway Bank | 89,909 | 15.06 | 35,813 | 6.00 | 47,751 | 8.00 |
| Common Equity Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | 72,741 | 12.08 | N/A | N/A | N/A | N/A |
| Northway Bank | 89,909 | 15.06 | 26,860 | 4.50 | 38,797 | 6.50 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| Consolidated | 92,466 | 10.45 | 35,407 | 4.00 | N/A | N/A |
| Northway Bank | 89,909 | 10.22 | 35,199 | 4.00 | 43,999 | 5.00 |
| As of December 31, 2016: | | | | | | |
| Total Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | $ 95,186 | 16.23 % | $ 46,922 | 8.00 % | N/A | N/A |
| Northway Bank | 92,786 | 15.95 | 46,544 | 8.00 | $ 58,180 | 10.00 % |
| Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | 87,565 | 14.93 | 35,192 | 6.00 | N/A | N/A |
| Northway Bank | 85,224 | 14.65 | 34,908 | 6.00 | 46,544 | 8.00 |
| Common Equity Tier 1 Capital (to Risk Weighted Assets): | | | | | | |
| Consolidated | 68,082 | 11.61 | N/A | N/A | N/A | N/A |
| Northway Bank | 85,224 | 14.65 | 26,181 | 4.50 | 37,817 | 6.50 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| Consolidated | 87,565 | 9.83 | 35,649 | 4.00 | N/A | N/A |
| Northway Bank | 85,224 | 9.61 | 35,469 | 4.00 | 44,336 | 5.00 |

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

As of December 31, 2017, the Bank is restricted from declaring dividends to Northway in an amount greater than approximately $50,018, as such declaration would decrease capital below the Bank's required minimum level of regulatory capital.

Under New Hampshire state law, the Bank may pay dividends only out of net profits. The State of New Hampshire Banking Commissioner's (Commissioner's) approval is required for dividend payments which exceed the current year's net profits and retained net profits from the preceding two years. As of December 31, 2017, the Bank is restricted from declaring dividends to the Company in an amount greater than $15,146 without the Commissioner's approval.

## NOTE 12 OTHER NONINTEREST EXPENSE

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

| | 2017 | 2016 |
|---|---|---|
| Professional fees | $ 1,883 | $ 2,082 |
| Software expenses | 922 | 915 |
| ATM & debit card expenses | 774 | 778 |
| Telecommunications | 393 | 401 |
| Advertising | 156 | 180 |
| Other | 2,415 | 3,674 |
| | $ 6,543 | $ 8,030 |

## NOTE 13 FEDERAL AND STATE TAXES

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

| | 2017 | 2016 |
|---|---|---|
| Current | | |
| Federal | $ 1,886 | $ 1,216 |
| State | 425 | (42) |
| | 2,311 | 1,174 |
| Deferred | | |
| Federal | 162 | (351) |
| Change in federal tax rates | 20 | - |
| State | (45) | 123 |
| | 137 | (228) |
| Total | $ 2,448 | $ 946 |

On December 22, 2017, the U. S. federal government enacted a tax bill, H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Act). Among other provisions, the Tax Act reduces the historical corporate income tax rate to a newly enacted rate of 21 percent for tax years beginning after December 31, 2017. At the date the new legislation is enacted, under ASC 740, Income Taxes, the Company is required to recognize the effects of the change in tax law and rates on its deferred tax assets and liabilities. As a result of the above Tax Act and the revaluation of deferred tax assets and liabilities at December 31, 2017, the Company's income tax expense increased by $20 in 2017.

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

## NOTE 13 FEDERAL AND STATE TAXES (CONTINUED)

| | 2017 | 2016 |
|---|---|---|
| Deferred income tax assets | | |
| Allowance for loan losses | $ 2,029 | $ 3,170 |
| Interest on nonaccrual loans | 234 | 339 |
| Net unrealized holding loss on securities available-for-sale | 159 | 1,042 |
| Net unrealized holding loss on limited partnership | - | 5 |
| Supplemental pension | 781 | 1,065 |
| Contribution carry-forward | 8 | 10 |
| New Hampshire Business Enterprise Tax credit carryforward | 81 | 19 |
| Accruals and reserves | 30 | 26 |
| Alternative Minimum Tax (AMT) tax credit carryforward | 1,273 | 1,255 |
| Other | 31 | 19 |
| | 4,626 | 6,950 |
| Deferred income tax liabilities | | |
| Depreciation | (397) | (776) |
| Amortization of goodwill and core deposit intangible | (2,457) | (3,366) |
| Net unrealized gain on interest rate swaps | (185) | (253) |
| | (3,039) | (4,395) |
| Deferred income tax asset, net | $ 1,587 | $ 2,555 |

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

Total income tax expense for the years ended December 31, 2017 and 2016 differs from the "expected" federal income tax expense at the 34% statutory rate for the following reasons:

| | 2017 | 2016 |
|---|---|---|
| Expected federal income taxes | 34.0 % | 34.0 % |
| Interest on municipal securities available-for-sale and municipal loans | (10.2) | (13.6) |
| Rate change | 0.2 | - |
| State expense, net of federal expense | 2.7 | 1.1 |
| Other | (1.5) | (2.4) |
| Effective tax rate | 25.2 % | 19.1 % |

It is the Company’s policy to provide for uncertain tax positions and the related interest and penalties based upon management’s assessment of whether a tax benefit is more likely than not to be sustained upon examination by tax authorities. As of December 31, 2017 and 2016, there were no material uncertain tax positions related to federal and state tax matters. The Company’s income tax returns are subject to review and examination by federal and state taxing authorities. The Company is currently open to audit under the applicable statutes of limitations by federal and state taxing authorities for the years ended December 31, 2014 through 2017.

## NOTE 14 EMPLOYEE BENEFITS

### *Pension Plan*

The Company previously maintained a trusteed non-contributory pension plan (the “Plan”) covering substantially all full-time employees. Assuming retirement at age 65 after 30 years or more of service, the benefits are computed as the sum of 1% of final average earnings up to a covered compensation limit, plus 0.65% of final average earnings in excess of covered compensation, times years of service, up to 30. Final average earnings are defined as the five consecutive years out of the employee’s last ten

## NOTE 14 EMPLOYEE BENEFITS (CONTINUED)

years of employment during which compensation is highest. The amounts contributed to the Plan are determined annually on the basis of (a) the maximum amount that can be deducted for federal income tax purposes, or (b) the amount certified by a consulting actuary as necessary to avoid an accumulated funding deficiency as defined by the Employee Retirement Income Security Act of 1974. Contributions are intended to provide not only benefits attributed to service to date, but also for those expected to be earned in the future.

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

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

| | 2016 |
|---|---|
| Obligations and funded status | |
| | |
| Change in benefit obligation | |
| Projected benefit obligation at beginning of year | $ 16,393 |
| Service cost | - |
| Interest cost | 571 |
| Actuarial loss | 1,834 |
| Benefits paid | (395) |
| Curtailment gain | - |
| Settlement payments | (16,216) |
| Settlement gain | (2,187) |
| Projected benefit obligation at end of year | - |
| | |
| Change in plan assets | |
| Fair value of plan assets at beginning of year | 15,669 |
| Actual return on plan assets | 938 |
| Employer contributions | 4 |
| Benefits paid | (395) |
| Settlement payments | (16,216) |
| Fair value of plan assets at end of year | - |
| | |
| Funded status at end of year | $ - |
| | |
| Amounts recognized in accumulated other comprehensive loss consist of: | |
| Unrecognized prior service credit | $ - |
| Unrecognized net loss | - |
| Total | $ - |
| | |
| Accumulated benefit obligation | $ - |

## NOTE 14 EMPLOYEE BENEFITS (CONTINUED)

| | 2016 |
|---|---|
| Net periodic pension cost | |
| Service cost | $ - |
| Interest cost | 571 |
| Expected return on plan assets | (559) |
| Amortization of prior service credit | - |
| Amortization of net actuarial loss | 136 |
| Recognized curtailment loss | - |
| Recognized settlement loss | 3,077 |
| Net periodic pension cost | 3,225 |
| Other changes in plan assets and benefit obligations recognized in other comprehensive (income)/loss | |
| Net actuarial gain for period | (732) |
| Amortization of prior service credit | - |
| Amortization of net actuarial loss | (136) |
| Recognized curtailment loss | - |
| Recognized settlement loss | (3,077) |
| Total | (3,945) |
| Total recognized net periodic pension cost and other comprehensive income | $ (720) |

**Assumptions**

| | 2016 |
|---|---|
| Weighted-average assumptions used to determine pension obligations at measurement date | |
| Discount rate | N/A % |
| Rate of compensation increase | N/A |
| Weighted-average assumptions used to determine net periodic pension cost for the year ended December 31, 2016 | |
| Discount rate | 4.25 % |
| Expected long-term rate of return on plan assets | 4.25 |

### *401(k) Plan*

The Company offers a contributory 401(k) Plan. Under the Northway Financial, Inc. 401(k) and Profit Sharing Plan (the "401(k) Plan"), employees are eligible to participate after attaining age 21, completing six months of service and having been credited with at least 1,000 hours of service. Under the 401(k) Plan during 2017 and 2016, the Company matched 100% of the first 3% of employee contributions and 50% of the next 2% of employee contributions. Total 401(k) Plan matching expense in 2017 and 2016 amounted to $423 and $385, respectively. There was a profit sharing contribution expense of $299 and $0 for the years ended December 31, 2017 and 2016, respectively.

### *Supplemental Executive Retirement Plan (SERP)*

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

The SERP consists of two components. The first component is a distribution of the account balance in equal installments over the ten years following the CEO's retirement without interest. This account balance reflects the cumulative net appreciation in a life insurance policy with a gross-up to reflect the Company's tax savings. The net appreciation is the gain in the surrender value of the life insurance policy less the cost of the premiums and benefit payments. The cost of premiums and benefits for 2017 was 1.80%. The account balance at the November 19, 2017 plan year end was $1,573. If the CEO dies before the end of the ten-year

period, his beneficiary receives the unpaid portion in a lump sum. The second component is a lifetime distribution beginning in the second year following retirement equal to the annual net appreciation in the life insurance policy with a gross-up to reflect the Company's tax savings. As of December 31, 2017 and 2016, the Company has accrued a liability related to the SERP in the amount of $2,786 and $2,642, respectively. The respective liabilities reflect the present value of all expected postretirement benefits. In the event of the CEO's death while employed by the Company, the SERP permits a death benefit of $2,000 to be paid to his beneficiary.

*Change in Control*

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

## NOTE 15 COMMITMENTS AND CONTINGENT LIABILITIES

The Company is obligated under non-cancelable leases expiring between January 2019 and March 2023. Options to renew for additional terms are included under certain lease agreements and are not included in the table below. The Company has one cancelable lease expiring in May 2021. The total minimum rental due in future periods under these existing agreements is as follows as of December 31, 2017:

| | |
|---|---|
| 2018 | $ 483 |
| 2019 | 382 |
| 2020 | 352 |
| 2021 | 196 |
| 2022 | 126 |
| Thereafter | 24 |
| | $ 1,563 |

Rent expense for the years ended December 31, 2017 and 2016 amounted to $573 and $559, respectively.

The Company is obligated under a Service Agreement with Enhanced Communications of Northern New England Inc. to pay a termination charge equal to 100% of the monthly recurring charge times the number of months remaining in the service agreement. The agreement was effective December 23, 2015 for sixty months. At December 31, 2017, the remaining term was thirty-five months for a total commitment of $210.

## NOTE 16 FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

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

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

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

| | 2017 | 2016 |
|---|---|---|
| Financial instruments whose contract amounts represent credit risk: | | |
| Unadvanced portions of home equity loans | $ 28,193 | $ 23,604 |
| Unadvanced portions of lines of credit | 45,488 | 41,803 |
| Unadvanced portions of commercial real estate loans | 9,609 | 9,963 |
| Unadvanced portions of Bounce Protection ™ | 13,612 | 14,024 |
| Commitments to originate municipal loans | 20,000 | - |
| Commitments to originate all other loans | 19,527 | 13,958 |
| Standby letters of credit | 1,651 | 1,637 |
| Total | $ 138,080 | $ 104,989 |

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

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

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance by a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers. As of December 31, 2017 and 2016, the maximum potential amount of the Company's obligation was $1,651 and $1,637, respectively, for financial and standby letters of credit. The Company's outstanding letters of credit generally have a term of less than one year. If a letter of credit is drawn upon, the Company may seek recourse through the customer's underlying line of credit. If the customer's line of credit is also in default, the Company may take possession of the collateral, if any, securing the line of credit.

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

## NOTE 17 ON-BALANCE SHEET DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

*Risk Management Policies – Hedging Instruments*

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

*Interest Rate Risk Management – Cash Flow Hedging Instruments*

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

agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

At December 31, 2017 and 2016, the information pertaining to outstanding interest rate swap agreements used to hedge variable rate debt is as follows:

| | | 2017 | | 2016 |
|---|---|---|---|---|
| Notional amount | $ | 20,000 | $ | 20,000 |
| Weighted average pay rate | | 1.20 % | | 1.20 % |
| Weighted average receive rate | | 3-month LIBOR % | | 3-month LIBOR % |
| Weighted average maturity in years | | 3.71 | | 4.71 |
| Unrealized gain relating to interest rate swaps | $ | 696 | $ | 638 |

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

During 2017, no interest rate swap agreements were terminated prior to maturity. At December 31, 2017 and 2016, the unrealized gain relating to interest rate swaps was recorded in derivative liabilities in accordance with ASC 815. Changes in the fair value of interest rate swaps designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings. None of the other comprehensive income was reclassified into interest expense during the year ended December 31, 2017.

Risk management results for the years ended December 31, 2017 and 2016 related to the balance sheet hedging of long-term debt indicates that the hedges were 100% effective and that there was no component of the derivative instruments' gain or loss which was excluded from the assessment of hedge effectiveness.

None of the losses reported in other comprehensive income related to the interest rate swaps were expected to be reclassified into interest expense as a yield adjustment of the hedged borrowings during the twelve-month period ending December 31, 2018.

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

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

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

There were no derivatives held related to mortgage banking activities during 2017 and 2016, nor outstanding as of December 31, 2017 and 2016.

*Collateral Requirements*

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

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

By using derivatives, the Company is exposed to credit risk to the extent that counterparties to the derivative contracts do not

perform as required. Should a counterparty fail to perform under the terms of a derivative contract, the Company's counterparty credit risk is equal to the amount reported as a derivative asset in the consolidated balance sheet. The Company seeks to minimize counterparty credit risk through credit approvals, limits, monitoring procedures, execution of master netting arrangements and obtaining collateral, where appropriate. Counterparties to the Company's derivatives include major financial institutions with investment grade credit ratings from the major rating agencies. As such, management believes the risk of incurring credit losses on derivative contracts with those counterparties is remote and losses, if any, would be immaterial.

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

At December 31, 2017 and December 31, 2016, the Company had seven and four such agreements, respectively, outstanding with commercial business customers. The Company pays interest to the customers at a floating rate on the notional amount and receives interest from the customers at a fixed rate on the same notional amount. Concurrently, the Company entered into offsetting interest rate swaps with a financial institution counterparty. In the offsetting swaps, the Company pays the counterparty interest at the same fixed rate on the same notional amount as the swap entered into with the customers, and receives interest from the counterparty for the same floating rate on the same notional amount.

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

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

| | No. of Contracts | Notional Amount | Weighted Average maturity (In years) | Weighted Average Rate Received | Weighted Average Rate Paid | Estimated Fair Value |
|---|---|---|---|---|---|---|
| December 31, 2017 | | | | | | |
| Interest rate swap - customer | 7 | $ 32,532 | 9.71 | 1-mo LIBOR +1.96% | 3.98% | $ (630) |
| Interest rate swap - counterparty | 7 | 32,532 | 9.71 | 3.98% | 1-mo LIBOR +1.96% | 630 |
| December 31, 2016 | | | | | | |
| Interest rate swap - customer | 4 | $ 24,471 | 11.92 | 1-mo LIBOR +1.86% | 3.77% | $ (684) |
| Interest rate swap - counterparty | 4 | 24,471 | 11.92 | 3.77% | 1-mo LIBOR +1.86% | 684 |

As of December 31, 2017 and December 31, 2016, the Company held restricted cash in the amount of $1,250 and $1,650, respectively. In addition, a correspondent bank held restricted cash in the amount of $150 and $0, respectively. All restricted cash held, whether by the Company or the correspondent bank, is collateral for interest rate swaps on the Company's behalf.

## NOTE 18 FAIR VALUE MEASUREMENTS

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

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

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

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

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

## NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

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

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

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

Cash flow hedging swaps: The carrying amount reported in the consolidated balance sheets for Cash flow hedging swaps represent the fair value of the instruments. The fair value is estimated using discounted cash flow analysis using interest rates currently being offered for similar instruments.

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

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

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

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

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

| | December 31, 2017 | | | | |
|---|---|---|---|---|---|
| | Carrying | Fair Value | | | |
| | Amount | Level 1 | Level 2 | Level 3 | Total |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 25,091 | $ 25,091 | $ - | $ - | $ 25,091 |
| Securities available-for-sale | 258,109 | 16,706 | 241,403 | - | 258,109 |
| FHLBB stock | 1,421 | 1,421 | - | - | 1,421 |
| Loans held-for-sale | 616 | - | 625 | - | 625 |
| Loans, net | 565,294 | - | - | 565,328 | 565,328 |
| Accrued interest receivable | 2,787 | 2,787 | - | - | 2,787 |
| Derivative - interest rate swaps | 630 | - | 630 | - | 630 |
| Derivative - cash flow hedging swaps | 696 | - | 696 | - | 696 |
| Financial liabilities: | | | | | |
| Deposits | 722,755 | 612,309 | 111,815 | - | 724,124 |
| Junior subordinated debentures | 20,620 | - | 19,688 | - | 19,688 |
| Derivative - interest rate swaps | 630 | - | 630 | - | 630 |

## NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

| | December 31, 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying | Fair Value | | | |
| | Amount | Level 1 | Level 2 | Level 3 | Total |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 44,854 | $ 44,854 | $ - | $ - | $ 44,854 |
| Securities available-for-sale | 261,008 | 19,377 | 241,631 | - | 261,008 |
| FHLBB stock | 1,398 | 1,398 | - | - | 1,398 |
| Loans held-for-sale | 242 | - | 247 | - | 247 |
| Loans, net | 545,594 | - | - | 549,541 | 549,541 |
| Accrued interest receivable | 2,579 | 2,579 | - | - | 2,579 |
| Derivative - interest rate swaps | 684 | - | 684 | - | 684 |
| Derivative - cash flow hedging swaps | 638 | - | 638 | - | 638 |
| Financial liabilities: | | | | | |
| Short-term borrowings | 50,528 | 50,528 | - | - | 50,528 |
| Junior subordinated debentures | 20,620 | - | 17,994 | - | 17,994 |
| Derivative - interest rate swaps | 684 | - | 684 | - | 684 |

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

At December 31, 2017 and 2016, all the Company's financial instruments were held for purposes other than trading.

### *Limitations*

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

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

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

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

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

Level 3 - Valuations for assets and liabilities that are derived from other methodologies, including option pricing models, discounted cash flow models and similar techniques, are not based on market exchange, dealer, or broker traded transactions.

## NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets and liabilities.

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

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value for December 31, 2017 and 2016. The Company did not have any significant transfers of assets between level 1 and level 2 of the fair value hierarchy during the year ended December 31, 2017.

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

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

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

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

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

The following summarizes assets measured at fair value on a recurring basis for the periods ending December 31, 2017 and 2016:

| | | Fair Value Measurements at Reporting Date Using: | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| December 31, 2017 | | | | |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 41,951 | $ - | $ 41,951 | $ - |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 95,543 | - | 95,543 | - |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 45,938 | - | 45,938 | - |
| State and political subdivision bonds | 57,971 | - | 57,971 | - |
| Marketable equity securities | 16,706 | 16,706 | - | - |
| Derivative - interest rate swaps | 630 | - | 630 | - |
| Derivative - cash flow hedging swaps | 696 | - | 696 | - |
| Total | $ 259,435 | $ 16,706 | $ 242,729 | $ - |

## NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

| | | Fair Value Measurements at Reporting Date Using: | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| December 31, 2016 | | | | |
| U.S. Treasury and other U.S. government agency and sponsored enterprise securities | $ 27,095 | $ - | $ 27,095 | $ - |
| U.S. government agency and sponsored enterprise mortgage-backed securities | 107,964 | - | 107,964 | - |
| Collateralized mortgage obligations issued by U.S. government agency and sponsored enterprises | 52,192 | - | 52,192 | - |
| State and political subdivision bonds | 54,380 | - | 54,380 | - |
| Marketable equity securities | 19,377 | 19,377 | - | - |
| Derivative - interest rate swaps | 684 | - | 684 | - |
| Derivative - cash flow hedging swaps | 638 | - | 638 | - |
| Total | $ 262,330 | $ 19,377 | $ 242,953 | $ - |

The following summarizes liabilities measured at fair value on a recurring basis for the years ending December 31, 2017 and 2016:

| | | Fair Value Measurements at Reporting Date Using: | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| December 31, 2017 | | | | |
| Derivative - interest rate swaps | 630 | - | 630 | - |
| Total | $ 630 | $ - | $ 630 | $ - |
| December 31, 2016 | | | | |
| Derivative - interest rate swaps | 684 | - | 684 | - |
| Total | $ 684 | $ - | $ 684 | $ - |

## NOTE 18 FAIR VALUE MEASUREMENTS (CONTINUED)

Under certain circumstances the Company makes adjustments to its assets and liabilities although they are not measured at fair value on an ongoing basis. The following table presents the carrying value of assets reflected in the consolidated balance sheets by caption and by level in the fair value hierarchy at December 31, 2017 and 2016, for which a nonrecurring change in fair value has been recorded.

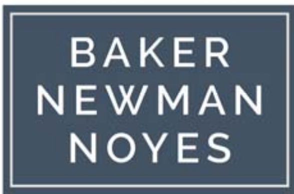
| | | Fair Value Measurements at Reporting Date Using: | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets Level 1 | Significant Other Observable Inputs Level 2 | Significant Unobservable Inputs Level 3 |
| December 31, 2017 | | | | |
| Impaired loans | $ 1,524 | $ - | $ - | $ 1,524 |
| Totals | $ 1,524 | $ - | $ - | $ 1,524 |
| December 31, 2016 | | | | |
| Impaired loans | $ 3,118 | $ - | $ - | $ 3,118 |
| OREO | 31 | - | - | 31 |
| Totals | $ 3,149 | $ - | $ - | $ 3,149 |

## NOTE 19 LEGAL CONTINGENCIES

The Company is subject to various claims and legal proceedings that arise in the ordinary course of business. Management believes that any liability that may ultimately result from the resolution of these matters will not have a material effect on its consolidated financial statements.

## NOTE 20 SUBSEQUENT EVENTS

Management has evaluated subsequent events through March 29, 2018, which is the date the consolidated financial statements were available to be issued. On February 1, 2018, the Company declared a cash dividend of $963, or $0.35 per share, to common shareholders on record as of February 5, 2018. The dividend was paid on February 20, 2018. There were no other subsequent events that require adjustment to or disclosure in the consolidated financial statements.




Baker Newman & Noyes LLC
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# INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders
Northway Financial, Inc.

## Report on the Financial Statements

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

## Management's Responsibility for the Financial Statements

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

## Auditors' Responsibility

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

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

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

## Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Northway Financial, Inc. and Subsidiary as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Baker Newman & Noyes LLC

Portsmouth, New Hampshire
March 29, 2018

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