

BAR HARBOR BANKSHARES  
Form 10-Q  
August 08, 2016  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

*(Mark One)*

**☐ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2016**

**OR**

**☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: **01-13349**

**BAR HARBOR BANKSHARES**

(Exact name of registrant as specified in its charter)

**Maine**  
(State or other jurisdiction of  
incorporation or organization)

**01-0393663**  
(I.R.S. Employer  
Identification Number)

**PO Box 400**  
**82 Main Street, Bar Harbor, ME**  
(Address of principal executive offices)

**04609-0400**  
(Zip Code)

**(207) 288-3314**

(Registrant's telephone number, including area code)

**Inapplicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act: Large accelerated filer  Accelerated filer  Non-accelerated filer (do not check if a smaller reporting company)  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (As defined in Rule 12B-2 of the Exchange Act): YES:  NO:

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

| <u>Class of Common Stock</u> | <u>Number of Shares Outstanding August 1, 2016</u> |
|------------------------------|--|
| \$2.00 Par Value             | 6,032,894  |

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**PART I. FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****JUNE 30, 2016 AND DECEMBER 31, 2015****(in thousands, except share and per share data)***(unaudited)*

|  | <b>June 30,</b>    | <b>December</b>    |
|--|--------------------|--------------------|
|  | <b>2016</b>        | <b>31,</b>         |
|  |                    | <b>2015</b>        |
| <b>Assets</b>                                  |                    |                    |
| Cash and cash equivalents                      | \$ 25,867          | \$ 9,720           |
| Securities available for sale, at fair value   | 532,590            | 504,969            |
| Federal Home Loan Bank stock                   | 26,713             | 21,479             |
| Loans  | 1,049,022          | 990,070            |
| Allowance for loan losses                      | (9,891)            | (9,439)            |
| Loans, net of allowance for loan losses        | 1,039,131          | 980,631            |
| Premises and equipment, net                    | 22,951             | 20,674             |
| Goodwill                                       | 4,935              | 4,935              |
| Bank owned life insurance                      | 24,131             | 23,747             |
| Other assets                                   | 11,231             | 13,900             |
| <b>TOTAL ASSETS</b>                            | <b>\$1,687,549</b> | <b>\$1,580,055</b> |
| <b>Liabilities</b>                             |                    |                    |
| <b>Deposits:</b>                               |                    |                    |
| Demand and other non-interest bearing deposits | \$ 84,123          | \$ 86,577          |
| NOW accounts                                   | 159,015            | 160,394            |
| Savings and money market deposits              | 289,820            | 299,087            |
| Time deposits                                  | 456,858            | 396,729            |
| Total deposits                                 | 989,816            | 942,787            |
| Short-term borrowings                          | 345,478            | 333,909            |
| Long-term advances from Federal Home Loan Bank | 174,624            | 135,882            |
| Junior subordinated debentures                 | 5,000              | 5,000              |
| Other liabilities                              | 7,400              | 8,325              |
| <b>TOTAL LIABILITIES</b>                       | <b>1,522,318</b>   | <b>1,425,903</b>   |

## Shareholders' equity

Capital stock, par value \$2.00; authorized 20,000,000 and 10,000,000 shares;

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|   |                    |                    |
|---|--------------------|--------------------|
| issued 6,788,407 shares at June 30, 2016 and December 31, 2015,<br>respectively   | 13,577             | 13,577             |
| Surplus   | 22,249             | 21,624             |
| Retained earnings   | 127,672            | 122,260            |
| Accumulated other comprehensive income:   |                    |                    |
| Prior service cost and unamortized net actuarial losses on employee<br>benefit plans, net of tax of (\$222) and (\$249), at June 30, 2016 and<br>December 31, 2015,<br>respectively | (412)              | (463)              |
| Net unrealized appreciation on securities available for sale, net of tax<br>of \$6,020 and \$2,828, at June 30, 2016 and December 31, 2015,<br>respectively                         | 11,180             | 5,251              |
| Portion of OTTI attributable to non-credit gains, net of tax of \$73 and<br>\$249, at<br>June 30, 2016 and December 31, 2015, respectively  | 135                | 462                |
| Net unrealized depreciation on derivative instruments, net of tax<br>of (\$1,299) and (\$873), at June 30, 2016 and December 31, 2015,<br>respectively                              | (2,412)            | (1,621)            |
| Total accumulated other comprehensive income  | 8,491              | 3,629              |
| Less: cost of 758,722 and 778,196 shares of treasury stock at June 30,<br>2016 and<br>December 31, 2015, respectively   | (6,758)            | (6,938)            |
| <b>TOTAL SHAREHOLDERS' EQUITY</b>   | <b>165,231</b>     | <b>154,152</b>     |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>   | <b>\$1,687,549</b> | <b>\$1,580,055</b> |

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

## BAR HARBOR BANKSHARES AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(in thousands, except per share data)

*(unaudited)*

|   | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|-----------------------------------|----------|------------------------------|----------|
|   | 2016                              | 2015     | 2016                         | 2015     |
| Interest and dividend income:                       |                                   |          |                              |          |
| Interest and fees on loans                          | \$10,249                          | \$ 9,645 | \$20,332                     | \$19,322 |
| Interest on securities                              | 3,900                             | 3,732    | 7,805                        | 7,494    |
| Dividend on FHLB stock                              | 205                               | 95       | 381                          | 189      |
| Total interest and dividend income                  | 14,354                            | 13,472   | 28,518                       | 27,005   |
| Interest expense:                                   |                                   |          |                              |          |
| Deposits  | 1,599                             | 1,460    | 3,176                        | 2,913    |
| Short-term borrowings                               | 532                               | 253      | 982                          | 492      |
| Long-term debt                                      | 841                               | 873      | 1,642                        | 1,716    |
| Total interest expense                              | 2,972                             | 2,586    | 5,800                        | 5,121    |
| Net interest income                                 | 11,382                            | 10,886   | 22,718                       | 21,884   |
| Provision for loan losses                           | 150                               | 400      | 615                          | 895      |
| Net interest income after provision for loan losses | 11,232                            | 10,486   | 22,103                       | 20,989   |
| Non-interest income:                                |                                   |          |                              |          |
| Trust and other financial services                  | 955                               | 985      | 1,903                        | 1,930    |
| Service charges on deposit accounts                 | 252                               | 255      | 463                          | 453      |
| Debit card income                                   | 430                               | 402      | 830                          | 768      |
| Securities gains                                    | 1,699                             | 587      | 3,135                        | 1,206    |
| Other operating income                              | 278                               | 274      | 611                          | 488      |
| Total non-interest income                           | 3,614                             | 2,503    | 6,942                        | 4,845    |
| Non-interest expense:                               |                                   |          |                              |          |
| Salaries and employee benefits                      | 4,799                             | 4,269    | 9,816                        | 8,621    |
| Occupancy expense                                   | 594                               | 567      | 1,163                        | 1,147    |
| Furniture and equipment expense                     | 558                               | 580      | 1,147                        | 1,145    |
| Debit card expenses                                 | 120                               | 112      | 237                          | 208      |
| FDIC insurance assessments                          | 218                               | 210      | 435                          | 411      |
| Other operating expense                             | 2,442                             | 1,863    | 3,930                        | 3,402    |
| Total non-interest expense                          | 8,731                             | 7,601    | 16,728                       | 14,934   |
| Income before income taxes                          | 6,115                             | 5,388    | 12,317                       | 10,900   |

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|                                      |          |          |          |          |
|--------------------------------------|----------|----------|----------|----------|
| Income taxes                         | 1,804    | 1,515    | 3,600    | 3,146    |
| Net income                           | \$ 4,311 | \$ 3,873 | \$ 8,717 | \$ 7,754 |
| <b><u>Per Common Share Data:</u></b> |          |          |          |          |
| Basic earnings per share             | \$ 0.72  | \$ 0.65  | \$ 1.45  | \$ 1.30  |
| Diluted earnings per share           | \$ 0.71  | \$ 0.64  | \$ 1.43  | \$ 1.28  |

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

## BAR HARBOR BANKSHARES AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(in thousands)

(unaudited)

|  | <b>Three Months<br/>Ended<br/>June 30,</b> |             |
|--|--|-------------|
|  | <b>2016</b>                                | <b>2015</b> |
| Net income   | \$ 4,311                                   | \$ 3,873    |
| Other comprehensive income:  |  |             |
| Net unrealized appreciation (depreciation) on securities available for sale,                               |  |             |
| net of tax of \$1,537 and (\$2,308), respectively  | 2,854                                      | (4,288)     |
| Less reclassification adjustment for net gains related to securities available for sale                    |  |             |
| included in net income, net of tax of (\$595) and (\$205), respectively                                    | (1,105)                                    | (382)       |
| Net unrealized (depreciation) appreciation on interest rate derivatives,                                   |  |             |
| net of tax of (\$176) and \$122, respectively  | (327)                                      | 227         |
| Net amortization of prior service cost and actuarial loss for supplemental executive retirement plan,      |  |             |
| net of related tax of \$2 and \$3, respectively  | 4  | 6           |
| Actuarial gains on supplemental executive retirement plan, net of related tax of \$0 and \$0, respectively | ---  | ---         |
| Total other comprehensive income (loss)  | 1,426                                      | (4,437)     |
| Total comprehensive income (loss)  | \$ 5,737                                   | \$ (564)    |
|  |  |             |
|  | <b>Six Months Ended<br/>June 30,</b>       |             |
|  | <b>2016</b>                                | <b>2015</b> |
| Net income   | \$ 8,717                                   | \$ 7,754    |
| Other comprehensive income:  |  |             |
| Net unrealized appreciation (depreciation) on securities available for sale,                               |  |             |
| net of tax of \$4,114 and (\$1,299), respectively  | 7,640                                      | (2,414)     |
| Less reclassification adjustment for net gains related to securities available for sale                    |  |             |
| included in net income, net of tax of (\$1,098) and (\$422), respectively                                  | (2,038)                                    | (784)       |
| Net unrealized depreciation on interest rate derivatives, net of tax of (\$426) and (\$87), respectively   | (791)                                      | (162)       |



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|  |          |          |
|--|----------|----------|
| Net amortization of prior service cost and actuarial loss for supplemental executive retirement plan,<br>net of related tax of \$5 and \$5, respectively | 9        | 13       |
| Actuarial gains on supplemental executive retirement plan, net of related tax of \$23 and \$0, respectively  | 42       | ---      |
| Total other comprehensive income (loss)  | 4,862    | (3,347)  |
| Total comprehensive income   | \$13,579 | \$ 4,407 |

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

## BAR HARBOR BANKSHARES AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2016 AND 2015

(in thousands, except share and per share data)

(unaudited)

|   | Capital<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total<br>Shareholders'<br>Equity |
|---|------------------|----------|----------------------|--|-------------------|----------------------------------|
| <b>Balance December 31, 2014</b>  | \$13,577         | \$20,905 | \$113,149            | \$ 6,691   | \$(8,035)         | \$146,287                        |
| Net income  | ---              | ---      | 7,754                | ---  | ---               | 7,754                            |
| Total other comprehensive loss  | ---              | ---      | ---                  | (3,347)  | ---               | (3,347)                          |
| Dividend declared:  |                  |          |                      |  |                   |                                  |
| Common stock (\$0.495 per share)  | ---              | ---      | (2,952)              | ---  | ---               | (2,952)                          |
| Purchase of Treasury Stock (221 shares)                                       | ---              | ---      | ---                  | ---  | (8)               | (8)                              |
| Stock options exercised (35,312 shares),<br><br>including related tax effects | ---              | 99       | (1)                  | ---  | 633               | 731                              |
| Recognition of stock based compensation<br>expense                            | ---              | 191      | ---                  | ---  | ---               | 191                              |
| Restricted stock grants (3,540 shares)  | ---              | (64)     | ---                  | ---  | 64                | ---                              |
| <b>Balance June 30, 2015</b>  | \$13,577         | \$21,131 | \$117,950            | \$ 3,344   | \$(7,346)         | \$148,656                        |

|   | Capital<br>Stock | Surplus  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total<br>Shareholders'<br>Equity |
|---|------------------|----------|----------------------|--|-------------------|----------------------------------|
| <b>Balance December 31, 2015</b>  | \$13,577         | \$21,624 | \$122,260            | \$ 3,629   | \$(6,938)         | \$154,152                        |
| Net income  | ---              | ---      | 8,717                | ---  | ---               | 8,717                            |
| Total other comprehensive income  | ---              | ---      | ---                  | 4,862  | ---               | 4,862                            |
| Dividend declared:  |                  |          |                      |  |                   |                                  |
| Common stock (\$0.270 per share)  | ---              | ---      | (3,219)              | ---  | ---               | (3,219)                          |
| Purchase of Treasury Stock (14,950 shares)                                    | ---              | ---      | ---                  | ---  | (481)             | (481)                            |
| Stock options exercised (14,804 shares),<br><br>including related tax effects | ---              | 92       | (86)                 | ---  | 349               | 355                              |
| Recognition of stock based compensation<br>expense                            | ---              | 845      | ---                  | ---  | ---               | 845                              |
| Restricted and performance stock grants<br>(19,620 shares)                    | ---              | (312)    | ---                  | ---  | 312               | ---                              |
| <b>Balance June 30, 2016</b>  | \$13,577         | \$22,249 | \$127,672            | \$ 8,491   | \$(6,758)         | \$165,231                        |

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

**BAR HARBOR BANKSHARES AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE SIX MONTHS ENDED JUNE 30, 2016 AND 2015****(in thousands)***(unaudited)*

|  | <b>2016</b> | <b>2015</b> |
|--|-------------|-------------|
| Cash flows from operating activities:  |             |             |
| Net income   | \$ 8,717    | \$ 7,754    |
| Adjustments to reconcile net income to net cash provided by operating activities:              |             |             |
| Depreciation and amortization of premises and equipment  | 788         | 861         |
| Amortization of core deposit intangible  | 46          | 46          |
| Provision for loan losses  | 615         | 895         |
| Net securities gains   | (3,135)     | (1,206)     |
| Net amortization of bond premiums and discounts  | 1,273       | 1,302       |
| Recognition of stock based compensation expense  | 845         | 191         |
| Gains on sale of other real estate owned   | ---         | (64)        |
| Net income from bank owned life insurance  | (384)       | (270)       |
| Net change in other assets   | (1,133)     | (30,306)    |
| Net change in other liabilities  | (925)       | (891)       |
| Net cash provided by (used in) operating activities  | 6,707       | (21,688)    |
| Cash flows from investing activities:  |             |             |
| Purchases of securities available for sale   | (110,269)   | (89,314)    |
| Proceeds from maturities, calls and principal paydowns of mortgage-backed securities           | 48,472      | 54,257      |
| Proceeds from sales of securities available for sale   | 44,656      | 20,428      |
| Purchases of Bank Owned Life Insurance   | ---         | 15,000      |
| Net increase in Federal Home Loan Bank stock   | (5,234)     | (2,239)     |
| Net increase in total loans originated   | (9,319)     | (42,550)    |
| Purchases of loans   | (49,796)    | (22,435)    |
| Proceeds from sale of other real estate owned  | ---         | 110         |
| Capital expenditures   | (3,065)     | (1,313)     |
| Net cash used in investing activities  | (84,555)    | (68,056)    |
| Cash flows from financing activities:  |             |             |
| Net increase in deposits   | 47,029      | 32,067      |
| Net (decrease) increase in securities sold under repurchase agreements and fed funds purchased | (6,431)     | 11,654      |
| Proceeds from Federal Home Loan Bank advances  | 63,750      | 66,493      |
| Repayments of Federal Home Loan Bank advances  | (7,008)     | (11,003)    |
| Purchases of Treasury Stock  | (481)       | (8)         |
| Proceeds from stock option exercises, including excess tax benefits                            | 355         | 731         |
| Payments of dividends  | (3,219)     | (2,952)     |

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|  |           |           |
|--|-----------|-----------|
| Net cash provided by financing activities          | 93,995    | 96,982    |
| Net increase in cash and cash equivalents          | 16,147    | 7,238     |
| Cash and cash equivalents at beginning of period   | 9,720     | 9,800     |
| Cash and cash equivalents at end of period         | \$ 25,867 | \$ 17,038 |
| Supplemental disclosures of cash flow information: |           |           |
| Cash paid during the period for:                   |           |           |
| Interest   | \$ 5,766  | \$ 5,146  |
| Income taxes                                       | \$ 3,926  | \$ 2,495  |
| Schedule of noncash investing activities:          |           |           |
| Transfers from loans to other real estate owned    | \$ ---    | \$ ---    |
| Restricted stock grants                            | \$ 312    | \$ 64     |

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

**BAR HARBOR BANKSHARES AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**JUNE 30, 2016**

**(Dollars in thousands, except share and per share data)**

*(unaudited)*

**Note 1: Basis of Presentation**

The accompanying consolidated interim financial statements are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All inter-company transactions have been eliminated in consolidation. Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation. The net income reported for the three and six months ended June 30, 2016, is not necessarily indicative of the results that may be expected for the year ending December 31, 2016, or any other interim periods.

The consolidated balance sheet at December 31, 2015, has been derived from audited consolidated financial statements at that date. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with United States ( U.S. ) generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X (17 CFR Part 210). Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, please refer to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2015, and notes thereto.

**Note 2: Subsequent Event**

On July 19, 2016, the Company's Board of Directors declared a third quarter 2016 regular cash dividend of 27.5 cents per share of Company common stock, representing an increase of 2.0 cents, or 7.8%, compared with the third quarter of 2015. The quarterly cash dividend is payable to all Company shareholders of record as of the close of business August 15, 2016, and will be paid on September 15, 2016. This represented the twenty-first consecutive quarter where the Company increased its quarterly cash dividend to shareholders.

**Note 3: Merger and Acquisition Activity**

On May 5, 2016, the Company announced the signing of a definitive agreement and plan of merger pursuant to which the Company will acquire Lake Sunapee Bank Group ( LSBG ) in an all-stock transaction valued at approximately \$143 million (the Merger ). The market expanding merger is expected to create efficiencies and strategic growth opportunities for both businesses through the leveraging of each other s platforms and capabilities, and will create the only community bank headquartered in New England with a market footprint in all three Northern New England states of Maine, New Hampshire and Vermont.

At closing, the combined institution is expected to have approximately \$3.3 billion in assets, \$2.4 billion in net loans, \$2.2 billion in deposits and over \$2.0 billion in assets under management. The Company will have a pro forma market cap of approximately \$350 million and 49 branches serving customers and communities across three states. The merger is expected to be completed in the fourth quarter of 2016 or the first quarter of 2017. The consummation of the Merger is subject to receipt of the requisite approval of the Company's shareholders and LSBG shareholders, receipt of all required regulatory approvals, and other customary closing conditions.

Included in the Company s second quarter and year-to-date non-interest expense was \$492 in non-recurring expenses related to the LSBG Merger, largely legal and other professional fees. The Company expects to continue to incur related non-recurring costs through the closing of the Merger.

#### **Note 4: Recent Accounting Pronouncements**

*ASU 2015-01, Income Statement - Extraordinary and Unusual Items (Subtopic 225-20) Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.* ASU 2015-01 eliminates from U.S. GAAP the concept of extraordinary items, which, among other things, required an entity to segregate extraordinary items considered to be unusual and infrequent from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. ASU 2015-01 became effective for us on January 1, 2016 and did not have a significant impact on the Company s financial statements.

*ASU 2015-16, Business Combinations (Topic 805) Simplifying the Accounting for Measurement-Period Adjustments.* ASU 2015-16 requires that adjustments to provisional amounts that are identified during the measurement period of a business combination be recognized in the reporting period in which the adjustment amounts are determined. Furthermore, the income statement effects of such adjustments, if any, must be calculated as if the accounting had been completed at the acquisition date. Any amounts that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date should be recorded in current-period earnings. Under previous guidance, adjustments to provisional amounts identified during the measurement period were to be recognized retrospectively. ASU 2015-16 became effective for us on January 1, 2016 and did not have a significant impact on the Company s financial statements.

*ASU 2016-01 Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which updates certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The new guidance requires equity investments to be measured at fair value with changes in fair value recognized in net income, excluding equity investments that are consolidated or accounted for under the equity

method of accounting. The new guidance allows equity investments without readily determinable fair values to be measured at cost minus impairment, with a qualitative assessment required to identify impairment. The new guidance also requires public companies to use exit prices to measure the fair value of financial instruments, eliminates the disclosure requirements related to measurement assumptions for the fair value of instruments measured at amortized cost and requires separate presentation of financial assets and liabilities based on form and measurement category. In addition, for liabilities measured at fair value under the fair value option, the changes in fair value due to changes in instrument-specific credit risk should be recognized in OCI. This guidance is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company is currently evaluating this guidance to determine the impact on its consolidated financial statements.

*ASU 2016-02, Leases (Topic 842).* The guidance in this ASU supersedes the leasing guidance in Topic 840, *Leases*. Under the new guidance, lessees are required to recognize lease assets and lease liabilities on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is currently evaluating this guidance to determine the impact on its consolidated financial statements.

*ASU 2016-05 Derivatives and Hedging (Topic 815) Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships.* ASU 2016-05 clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under ASC Topic 815 does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. ASU 2016-05 will be effective for us on January 1, 2017 and is not expected to have a significant impact on the Company's financial statements.

*ASU 2016-07, Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting.* The amendments affect all entities that have an investment that becomes qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. ASU 2016-07 simplifies the transition to the equity method of accounting by eliminating retroactive adjustment of the investment when an investment qualifies for use of the equity method, among other things. ASU 2016-07 will be effective for the Company on January 1, 2017 and is not expected to have a significant impact on our financial statements.

*ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.* Under ASU 2016-09 all excess tax benefits and tax deficiencies related to share-based payment awards should be recognized as income tax expense or benefit in the income statement during the period in which they occur. Previously, such amounts were recorded in the pool of excess tax benefits included in additional paid-in capital, if such pool was available. Because excess tax benefits are no longer recognized in additional paid-in capital, the



assumed proceeds from applying the treasury stock method when computing earnings per share should exclude the amount of excess tax benefits that would have previously been recognized in additional paid-in capital. Additionally, excess tax

benefits should be classified along with other income tax cash flows as an operating activity rather than a financing activity, as was previously the case. ASU 2016-09 also provides that an entity can make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. ASU 2016-09 changes the threshold to qualify for equity classification (rather than as a liability) to permit withholding up to the maximum statutory tax rates (rather than the minimum as was previously the case) in the applicable jurisdictions. ASU 2016-09 will be effective on January 1, 2017 and is not expected to have a significant impact on the Company's financial statements.

*ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.* ASU 2016-13, was issued to provide financial statement users with information about expected credit losses on financial instruments and other commitments to extend credit rather than the current incurred loss model. For public business entities, the new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating this guidance to determine the impact on its consolidated financial statements.

#### **Note 5: Management's Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, other-than-temporary impairments on securities, income tax estimates, and the valuation of intangible assets.

**Allowance for Loan Losses:** The allowance for loan losses (the allowance) is a significant accounting estimate used in the preparation of the Company's consolidated financial statements. The allowance is available to absorb losses inherent in the current loan portfolio and is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the loan portfolio, given past and present conditions. The allowance is increased by provisions charged to operating expense and by recoveries on loans previously charged off, and is decreased by loans charged off as uncollectible.

Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated regularly based on review of loans, with particular emphasis on non-performing and other loans that management believes warrant special consideration. The ongoing evaluation process includes a formal analysis, which considers among other factors: the character and size of the loan portfolio, business and economic conditions, real estate market conditions, collateral values, changes in product offerings or loan terms, changes in underwriting and/or collection policies, loan growth, previous charge-off experience, delinquency trends, non-performing loan trends, the performance of individual loans in relation to contract terms, and estimated fair values of collateral.

The allowance for loan losses consists of allowances established for specific loans including impaired loans; allowances for pools of loans based on historical charge-offs by loan types; and supplemental allowances that adjust historical loss experience to reflect current economic conditions, industry specific risks, and other observable data.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

**Other-Than-Temporary Impairments on Investment Securities:** One of the significant estimates relating to securities is the evaluation of other-than-temporary impairment ( OTTI ). If a decline in the fair value of a security is judged to be other-than-temporary, and management does not intend to sell the security and believes it is more-likely-than-not the Company will not be required to sell the security prior to recovery of cost or amortized cost, the portion of the total impairment attributable to the credit loss is recognized in earnings, and the remaining difference between the security's amortized cost basis and its fair value is included in other comprehensive income.

For impaired available for sale debt securities that management intends to sell, or where management believes it is more-likely-than-not that the Company will be required to sell, an OTTI charge is recognized in earnings equal to the difference between fair value and cost or amortized cost basis of the security. The fair value of the OTTI security becomes its new cost basis.

The evaluation of securities for impairments is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of securities should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period of unrealized losses. The Company has a security monitoring process that identifies securities that, due to certain characteristics, as described below, are subjected to an enhanced analysis on a quarterly basis.

Securities that are in an unrealized loss position are reviewed at least quarterly to determine if an OTTI is present based on certain quantitative and qualitative factors and measures. The primary factors considered in evaluating whether a decline in value of securities is other-than-temporary include: (a) the cause of the

impairment; (b) the financial condition, credit rating and future prospects of the issuer; (c) whether the underlying debtor is current on contractually obligated interest and principal payments; (d) the volatility of the securities' fair value; (e) performance indicators of the underlying assets in the security including default rates, delinquency rates, percentage of non-performing assets, loan to collateral value ratios, conditional payment rates, third party guarantees, current levels of subordination, vintage, and geographic concentration and; (f) any other information and observable data considered relevant in determining whether an OTTI has occurred, including the expectation of the receipt of all principal and interest due.

In addition, for securitized financial assets with contractual cash flows, such as private label mortgage-backed securities ( MBS ), the Company periodically updates its best estimate of cash flows over the life of the security. The Company's best estimate of cash flows is based upon assumptions consistent with the current economic environment, similar to those the Company believes market participants would use. Estimating future cash flows is a quantitative and qualitative process that incorporates information received from third party sources along with certain assumptions and judgments regarding the future performance of the underlying collateral. In addition, projections of expected future cash flows may change based upon new information regarding the performance of the underlying collateral.

**Income Taxes:** The Company uses the asset and liability method of accounting for income taxes. Under this 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 their respective tax bases. If current available information indicates that it is more-likely-than-not that deferred tax assets will not be realized, a valuation allowance is established. 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. Significant management judgment is required in determining income tax expense and deferred tax assets and liabilities. As of June 30, 2016 and December 31, 2015, there was no valuation allowance for deferred tax assets.

**Goodwill and Identifiable Intangible Assets:** In connection with acquisitions, the Company generally records as assets on its consolidated financial statements both goodwill and identifiable intangible assets, such as core deposit intangibles.

The Company evaluates whether the carrying value of its goodwill has become impaired, in which case the value is reduced through a charge to its earnings. Goodwill is evaluated for impairment at least annually, or upon a triggering event using certain fair value techniques. Goodwill impairment testing is performed at the segment (or reporting unit) level. Goodwill is assigned to reporting units at the date the goodwill is initially recorded. Once goodwill has been assigned to the reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or organically grown, are available to support the value of the goodwill.

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in accordance with the purchase method of accounting for business combinations. Goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce

the fair value of a reporting unit below its carrying amount. The Company completes its annual goodwill impairment test as of December 31 of each year. The impairment testing process is conducted by assigning assets and goodwill to each reporting unit. Currently, the Company's goodwill is evaluated at the entity level as there is only one reporting unit. The Company first assesses certain qualitative factors to determine if it is more-likely-than-not that the fair value of the reporting unit is less than its carrying value. If it is more-likely-than-not that the fair value of the reporting unit is less than the carrying value, then the fair value of each reporting unit is compared to the recorded book value ( step one ). If the fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and step two is not considered necessary. If the carrying value of a reporting unit

exceeds its fair value, the impairment test continues ( step two ) by comparing the carrying value of the reporting unit s goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill. The adjusted goodwill balance is the implied fair value of the goodwill. An impairment charge is recognized if the carrying fair value of goodwill exceeds the implied fair value of goodwill. At December 31, 2015, there was no indication of impairment that led the Company to believe it needed to perform a two-step test.

Any changes in the estimates used by the Company to determine the carrying value of its goodwill, or which otherwise adversely affect their value or estimated lives, would adversely affect the Company s consolidated results of operations.

### Note 6: Earnings Per Share

Basic earnings per share 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 earnings per share 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 Company, such as the Company s dilutive stock options and awards.

The following is a reconciliation of basic and diluted earnings per share for the three and six months ended June 30, 2016, and 2015:

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2016                           | 2015      | 2016                         | 2015      |
| Net income                                 | \$ 4,311                       | \$ 3,873  | \$ 8,717                     | \$ 7,754  |
| Weighted average common shares outstanding |                                |           |                              |           |
| Basic                                      | 6,021,316                      | 5,973,758 | 6,015,257                    | 5,963,704 |
| Effect of dilutive employee stock options  | 64,985                         | 90,655    | 68,110                       | 86,418    |
| Diluted                                    | 6,086,301                      | 6,064,413 | 6,083,367                    | 6,050,122 |
| Anti-dilutive options excluded from        |                                |           |                              |           |
| earnings per share calculation             | 75,763                         | 10,950    | 80,263                       | 11,197    |
| <b>Per Common Share Data:</b>              |                                |           |                              |           |
| Basic earnings per share                   | \$ 0.72                        | \$ 0.65   | \$ 1.45                      | \$ 1.30   |
| Diluted earnings per share                 | \$ 0.71                        | \$ 0.64   | \$ 1.43                      | \$ 1.28   |



**Note 7: Securities Available For Sale**

The following tables summarize the securities available for sale portfolio as of June 30, 2016, and December 31, 2015:

| <b>June 30, 2016</b>                |                           |                                       |  |                                 |
|-------------------------------------|---------------------------|---------------------------------------|--|---------------------------------|
| <b>Available for Sale:</b>          | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
| Mortgage-backed securities:         |                           |                                       |  |                                 |
| US Government-sponsored enterprises | \$323,684                 | \$ 9,693                              | \$ 397                                 | \$332,980                       |
| US Government agency                | 80,472                    | 1,993                                 | 97                                     | 82,368                          |
| Private label                       | 1,128                     | 218                                   | 19                                     | 1,327                           |
| Obligations of states and           |                           |                                       |  |                                 |
| political subdivisions thereof      | 109,898                   | 6,108                                 | 91                                     | 115,915                         |
| Total                               | \$515,182                 | \$18,012                              | \$ 604                                 | \$532,590                       |

| <b>December 31, 2015</b>            |                           |                                       |  |                                 |
|-------------------------------------|---------------------------|---------------------------------------|--|---------------------------------|
| <b>Available for Sale:</b>          | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Estimated<br/>Fair Value</b> |
| Mortgage-backed securities:         |                           |                                       |  |                                 |
| US Government-sponsored enterprises | \$304,106                 | \$ 5,042                              | \$2,155                                | \$306,993                       |
| US Government agency                | 78,408                    | 1,269                                 | 547                                    | 79,130                          |
| Private label                       | 2,713                     | 762                                   | 11                                     | 3,464                           |
| Obligations of states and           |                           |                                       |  |                                 |
| political subdivisions thereof      | 110,952                   | 4,758                                 | 328                                    | 115,382                         |
| Total                               | \$496,179                 | \$11,831                              | \$3,041                                | \$504,969                       |

**Securities Maturity Distribution:** The following table summarizes the maturity distribution of the amortized cost and estimated fair value of securities available for sale as of June 30, 2016. Actual maturities may differ from the final maturities noted below because issuers may have the right to prepay or call certain securities. In the case of MBS, actual maturities may also differ from expected maturities due to the amortizing nature of the underlying mortgage collateral, and the fact that borrowers have the right to prepay.

| <b>Securities Available for Sale</b>   | <b>Amortized<br/>Cost</b> | <b>Estimated<br/>Fair Value</b> |
|--|---------------------------|---------------------------------|
| Due one year or less                   | \$ 167                    | \$ 168                          |
| Due after one year through five years  | 5,592                     | 5,732                           |
| Due after five years through ten years | 13,889                    | 14,762                          |



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|                     |           |           |
|---------------------|-----------|-----------|
| Due after ten years | 495,534   | 511,928   |
| Total               | \$515,182 | \$532,590 |

**Securities Impairment:** As a part of the Company's ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be OTTI. For the three and six months ended June 30, 2016 and 2015, the Company did not have any OTTI losses recognized in earnings (before taxes).

Upon initial impairment of a security, total OTTI losses represent the excess of the amortized cost over the fair value. For subsequent impairments of the same security, total OTTI losses represent additional credit losses and or declines in fair value subsequent to the previously recorded OTTI losses, if

applicable. Unrealized OTTI losses recognized in accumulated other comprehensive income ( OCI ) represent the non-credit component of OTTI losses on debt securities. Net impairment losses recognized in earnings represent the credit component of OTTI losses on debt securities.

As of June 30, 2016, the Company held four private label MBS (debt securities) with a total amortized cost (i.e. carrying value) of \$48 for which OTTI losses have previously been recognized in pre-tax earnings dating back to the fourth quarter of 2008. For all of these securities, the Company previously recognized credit losses in excess of the unrealized losses currently in accumulated OCI, creating an unrealized gain of \$135, net of tax, as included in accumulated OCI as of June 30, 2016, compared with a net unrealized gain of \$462, net of tax, at December 31, 2015.

The OTTI losses previously recognized in earnings represented management's best estimate of credit losses inherent in the securities based on discounted, bond-specific future cash flow projections using assumptions about cash flows associated with the pools of mortgage loans underlying each security. In estimating those cash flows the Company takes a variety of factors into consideration including, but not limited to, loan level credit characteristics, current delinquency and non-performing loan rates, current levels of subordination and credit support, recent default rates and future constant default rate estimates, original and current loan to collateral value ratios, recent collateral loss severities and future collateral loss severity estimates, recent and historical conditional prepayment rates and future conditional prepayment rate assumptions, and other estimates of future collateral performance.

Despite elevated levels of delinquencies, defaults and losses in the underlying residential mortgage loan collateral, given credit enhancements resulting from the structures of the individual securities, the Company expects that as of June 30, 2016, it will recover the amortized cost basis of its private label MBS as depicted in the continuously unrealized loss table below and has therefore concluded that such securities were not OTTI as of that date. Nevertheless, given recent market conditions, it is possible that adverse changes in repayment performance and fair value could occur in future periods that would change the Company's current best estimates.

The following table displays the beginning balance of OTTI related to historical credit losses on debt securities held by the Company at the beginning of the current reporting period, as well as changes in credit losses recognized in pre-tax earnings for the three and six months ended June 30, 2016, and 2015.

|  | <b>2016</b>    | <b>2015</b>    |
|--|----------------|----------------|
| <b>Estimated credit losses as of March 31,</b>               | \$2,793        | \$3,413        |
| Additions for credit losses for securities on which          |                |                |
| OTTI has been previously recognized                          | ---            | ---            |
| Additions for credit losses for securities on which          |                |                |
| OTTI has not been previously recognized                      | ---            | ---            |
| Reductions for securities sold or paid off during the period | 1,096          | 233            |
| <b>Estimated credit losses as of June 30,</b>                | <b>\$1,697</b> | <b>\$3,180</b> |

|  |                |                |
|--|----------------|----------------|
| <b>Estimated credit losses as of prior year-end,</b>         | \$3,180        | \$3,413        |
| Additions for credit losses for securities on which          |                |                |
| OTTI has been previously recognized                          | ---            | ---            |
| Additions for credit losses for securities on which          |                |                |
| OTTI has not been previously recognized                      | ---            | ---            |
| Reductions for securities sold or paid off during the period | 1,483          | 233            |
| <b>Estimated credit losses as of June 30,</b>                | <b>\$1,697</b> | <b>\$3,180</b> |

As of June 30, 2016, based on a review of the remaining securities in the securities portfolio, the Company concluded that it expects to recover its amortized cost basis for such securities. This conclusion was based on the issuers continued satisfaction of the securities obligations in accordance with their contractual terms and the expectation that they will continue to do so through the maturity of the security, the expectation that the Company will receive the entire amount of future contractual cash flows, as well as the evaluation of the fundamentals of the issuers financial condition and other objective evidence. Accordingly, the Company concluded that any declines in the values of those securities were temporary and that any additional OTTI charges were not appropriate at June 30, 2016.

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The following table summarizes the fair value of securities with continuous unrealized losses for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer as of June 30, 2016 and December 31, 2015. All securities referenced are debt securities.

| Description of Securities:                                     | Less than 12 months |                       |                   | 12 months or longer |                       |                   | Total      |                       |                   |
|--|---------------------|-----------------------|-------------------|---------------------|-----------------------|-------------------|------------|-----------------------|-------------------|
|  | Estimated           |                       |                   | Estimated           |                       |                   | Estimated  |                       |                   |
|  | Fair Value          | Number of Investments | Unrealized Losses | Fair Value          | Number of Investments | Unrealized Losses | Fair Value | Number of Investments | Unrealized Losses |
| June 30, 2016  |                     |                       |                   |                     |                       |                   |            |                       |                   |
| Mortgage-backed securities:                                    |                     |                       |                   |                     |                       |                   |            |                       |                   |
| US Government-   |                     |                       |                   |                     |                       |                   |            |                       |                   |
| sponsored enterprises  | \$35,865            | 42                    | \$ 224            | \$ 9,678            | 22                    | \$ 173            | \$ 45,543  | 64                    | \$ 397            |
| US Government agency   | 7,619               | 11                    | 27                | 4,920               | 16                    | 70                | 12,539     | 27                    | 97                |
| Private label Obligations of states and political subdivisions | 198                 | 2                     | 10                | 159                 | 5                     | 9                 | 357        | 7                     | 19                |
| thereof  | 2,426               | 5                     | 7                 | 5,077               | 11                    | 84                | 7,503      | 16                    | 91                |
| Total  | \$46,108            | 60                    | \$ 268            | \$19,834            | 54                    | \$ 336            | \$ 65,942  | 114                   | \$ 604            |

| Description of Securities:  | Less than 12 months |                       |                   | 12 months or longer |                       |                   | Total      |                       |                   |
|-----------------------------|---------------------|-----------------------|-------------------|---------------------|-----------------------|-------------------|------------|-----------------------|-------------------|
|                             | Estimated           |                       |                   | Estimated           |                       |                   | Estimated  |                       |                   |
|                             | Fair Value          | Number of Investments | Unrealized Losses | Fair Value          | Number of Investments | Unrealized Losses | Fair Value | Number of Investments | Unrealized Losses |
| December 31, 2015           |                     |                       |                   |                     |                       |                   |            |                       |                   |
| Mortgage-backed securities: |                     |                       |                   |                     |                       |                   |            |                       |                   |
| US Government-              |                     |                       |                   |                     |                       |                   |            |                       |                   |
| sponsored enterprises       | \$112,770           | 142                   | \$1,342           | \$23,646            | 33                    | \$ 813            | \$136,416  | 175                   | \$2,155           |
| US Government agency        | 20,201              | 30                    | 326               | 11,232              | 22                    | 221               | 31,433     | 52                    | 547               |
| Private label               | 235                 | 2                     | 2                 | 178                 | 5                     | 9                 | 413        | 7                     | 11                |

Obligations of  
states and

political  
subdivisions

|         |           |     |         |          |    |         |           |     |         |
|---------|-----------|-----|---------|----------|----|---------|-----------|-----|---------|
| thereof | 14,853    | 25  | 210     | 3,700    | 11 | 118     | 18,553    | 36  | 328     |
| Total   | \$148,059 | 199 | \$1,880 | \$38,756 | 71 | \$1,161 | \$186,815 | 270 | \$3,041 |

For securities with unrealized losses, the following information was considered in determining that the impairments were not other-than-temporary:

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***Mortgage-backed securities issued by U.S. Government-sponsored enterprises:*** As of June 30, 2016, the total unrealized losses on these securities amounted to \$397, compared with \$2,155 at December 31, 2015. All of these securities were credit rated AA+ by the major credit rating agencies. Company management believes these securities have minimal credit risk, as these Government-sponsored enterprises play a vital role in the nation's financial markets. Management's analysis indicates that the unrealized losses at June 30, 2016 were attributed to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be OTTI at June 30, 2016.

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***Mortgage-backed securities issued by U.S. Government agencies:*** As of June 30, 2016, the total unrealized losses on these securities amounted to \$97, compared with \$547 at December 31, 2015. All of these securities were credit rated AA+ by the major credit rating agencies. Management's analysis indicates that these securities bear little or no credit risk because they are backed by the full faith and credit of the United States. The Company attributes the unrealized losses at June 30, 2016 to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased, and does not consider these securities to be OTTI at June 30, 2016.

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***Private label mortgage-backed securities:*** As of June 30, 2016, the total unrealized losses on the Bank's private label MBS amounted to \$19, compared with \$11 at December 31, 2015. The Company attributes the unrealized losses at June 30, 2016 to the current illiquid market for non-agency MBS, risk-related market pricing discounts for non-agency MBS and credit rating

downgrades on certain private label MBS owned by the Company. Based upon the foregoing considerations and the expectation that the Company will receive all of the future contractual cash flows related to the amortized cost on these securities, the Company does not consider there to be any additional OTTI with respect to these securities at June 30, 2016.

***Obligations of states of the U.S. and political subdivisions thereof:*** As of June 30, 2016, the total unrealized losses on the Bank's municipal securities amounted to \$91, compared with \$328 at December 31, 2015. The Bank's municipal securities primarily consist of general obligation bonds and to a lesser extent, revenue bonds. General obligation bonds carry less risk, as they are supported by the full faith, credit and taxing authority of the issuing government and in the cases of school districts, are additionally supported by state aid. Revenue bonds are generally backed by municipal revenue streams generated through user fees or lease payments associated with specific municipal projects that have been financed.

Municipal bonds are frequently supported with insurance, which guarantees that, in the event the issuer experiences financial problems, the insurer will step in and assume payment of both principal and interest. Historically, insurance support has strengthened an issuer's underlying credit rating to AAA or AA status. Starting in 2008, many of the insurance companies providing municipal bond insurance experienced financial difficulties and, accordingly, were downgraded by at least one of the major credit rating agencies. Consequently, a portion of the Bank's municipal bond portfolio was downgraded by at least one of the major credit rating agencies. Notwithstanding the credit rating downgrades, at June 30, 2016, the Bank's municipal bond portfolio did not contain any below investment grade securities as reported by major credit rating agencies. In addition, at June 30, 2016, all municipal bond issuers were current on contractually obligated interest and principal payments.

The Company attributes the unrealized losses in municipal bonds at June 30, 2016 to changes in current market yields and pricing spreads for similar securities since the date the underlying securities were purchased and, to a lesser extent, changes in credit ratings on certain securities. The Company also attributes the unrealized losses to ongoing media attention and market concerns about municipal budget deficits and the prolonged recovery from the national economic recession and the impact it might have on the future financial stability of municipalities throughout the country. Notwithstanding the foregoing considerations, the Company does not consider these municipal securities to be other-than-temporarily impaired at June 30, 2016.

At June 30, 2016, the Company had no intent to sell nor believed it is more-likely-than-not that it would be required to sell any of its impaired securities as identified and discussed immediately above, and therefore did not consider these securities to be other than temporarily impaired as of that date.

**Securities Gains and Losses:** The following table summarizes realized gains and losses on securities available for sale for the three and six months ended June 30, 2016 and 2015.

|                                    | <b>Proceeds</b>     |                 |                 | <b>Other</b>      |            |
|------------------------------------|---------------------|-----------------|-----------------|-------------------|------------|
|                                    | <b>from Sale of</b> |                 |                 | <b>Than</b>       |            |
|                                    | <b>Securities</b>   |                 |                 | <b>Temporary</b>  |            |
|                                    | <b>Available</b>    | <b>Realized</b> | <b>Realized</b> | <b>Impairment</b> |            |
|                                    | <b>for Sale</b>     | <b>Gains</b>    | <b>Losses</b>   | <b>Losses</b>     | <b>Net</b> |
| <b>Three months ended June 30,</b> |                     |                 |                 |                   |            |
| 2016                               | \$23,142            | \$1,699         | \$ ---          | \$ ---            | \$1,699    |
| 2015                               | \$11,487            | \$ 587          | \$ ---          | \$ ---            | \$ 587     |
| <b>Six months ended June 30,</b>   |                     |                 |                 |                   |            |
| 2016                               | \$44,655            | \$3,135         | \$ ---          | \$ ---            | \$3,135    |
| 2015                               | \$20,428            | \$1,206         | \$ ---          | \$ ---            | \$1,206    |

**Visa Class B Common Shares:** The Bank was a member of the Visa USA payment network and was issued Class B shares in connection with the Visa Reorganization and the Visa Inc. initial public offering in March 2008. The Visa Class B shares are transferable only under limited circumstances until they can be converted into shares of the publicly traded class of Visa stock. This conversion cannot happen until the settlement of certain litigation, which is indemnified by Visa members. Since its initial public offering, Visa has funded a litigation reserve based upon a change in the conversion ratio of Visa Class B shares into Visa Class A shares. At its discretion, Visa may continue to increase the conversion rate in connection with any settlements in excess of amounts then in escrow for that purpose and reduce the conversion rate to the extent that it adds any funds to the escrow in the future. Based on the existing transfer restriction and the uncertainty of the litigation, the Company has recorded its Visa Class B shares on its statements of condition at zero value for all reporting periods since 2008.

At June 30, 2016, the Bank owned 11,623 of Visa Class B shares with a then current conversion ratio to Visa Class A shares of 1.648 (or 19,158 Visa Class A shares). Upon termination of the existing transfer restriction and settlement of the litigation, and to the extent that the Bank continues to own such Visa Class B shares in the future, the Company expects to record its Visa Class A shares at fair value.

#### **Note 8: Loans and Allowance for Loan Losses**

Loans are carried at the principal amounts outstanding adjusted by partial charge-offs and net deferred loan origination costs or fees.

Interest on loans is accrued and credited to income based on the principal amount of loans outstanding. Residential real estate and home equity loans are generally placed on non-accrual status when reaching 90 days past due, or in process of foreclosure, or sooner if judged appropriate by management. Consumer loans are generally placed on non-accrual status when reaching 90 days or more past due, or sooner if management determines there is a reason to doubt full collectability of all outstanding principal and interest. Secured consumer loans are written down to realizable value and unsecured consumer loans are charged-off upon reaching 120 days past due. Commercial real estate loans and commercial business loans that are 90 days or more past due are generally placed on non-accrual status, unless secured by sufficient cash or other assets immediately convertible to cash, and the loan is in the process of collection. Commercial real estate and commercial business loans may be placed on non-accrual status prior to the 90 days delinquency date if management determines there is a reason to doubt full collectability of all outstanding principal and interest. When a loan has been placed on non-accrual status, previously accrued and uncollected interest is reversed against interest on loans. A loan can be returned to accrual status when there is evidence of an ability to adhere to the required repayment schedule and the loan has performed for a period of time, generally six months.

Commercial real estate and commercial business loans are considered impaired when it becomes probable the Bank will not be able to collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and collateral value. In considering loans for evaluation of impairment, management generally excludes smaller balance, homogeneous loans, residential mortgage loans, home equity loans, and all consumer loans, unless such loans were restructured in a troubled debt restructuring. These loans are collectively evaluated for risk of loss.



Loan origination, commitment fees and direct loan origination costs are deferred, and the net amount is amortized as an adjustment of the related loans' yield, using the level yield method over the estimated lives of the related loans.

The Company's lending activities are principally conducted in downeast, midcoast and central Maine.

The following table summarizes the composition of the loan portfolio as of June 30, 2016, and December 31, 2015:

## LOAN PORTFOLIO SUMMARY

|  | June 30,<br>2016 | December 31,<br>2015 |
|--|------------------|----------------------|
| Commercial real estate mortgages             | \$ 390,033       | \$371,002            |
| Commercial and industrial                    | 80,749           | 79,911               |
| Commercial construction and land development | 25,467           | 24,926               |
| Agricultural and other loans to farmers      | 33,081           | 31,003               |
| Total commercial loans                       | 529,330          | 506,842              |
| Residential real estate mortgages            | 446,933          | 408,401              |
| Home equity loans                            | 49,330           | 51,530               |
| Other consumer loans                         | 6,946            | 7,949                |
| Total consumer loans                         | 503,209          | 467,880              |
| Tax exempt loans                             | 16,352           | 15,244               |
| Net deferred loan costs and fees             | 131              | 104                  |
| Total loans                                  | 1,049,022        | 990,070              |
| Allowance for loan losses                    | (9,891)          | (9,439)              |
| Total loans net of allowance for loan losses | \$1,039,131      | \$980,631            |

**Loan Origination/Risk Management:** The Bank has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. The Bank's board of directors reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management and the board with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing loans and potential problem loans. The Bank seeks to diversify the loan portfolio as a means of managing risk associated with fluctuations in economic conditions.

Commercial Real Estate Mortgages: The Bank's commercial real estate mortgage loans are collateralized by liens on real estate, typically have variable interest rates and amortize over a 15 to 20 year period. These loans are underwritten primarily as cash flow loans and secondarily as loans secured by real estate. Payments on loans secured by such properties are largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Accordingly, repayment of these loans may be subject to adverse economic conditions to a greater extent than other types of loans. The Bank seeks to minimize these risks in a variety of ways, including giving careful consideration to the property's operating history, future operating projections, current and projected occupancy, location and physical condition in connection with underwriting these loans. The underwriting analysis also includes credit verification, analysis of global cash flows, appraisals and a review of the financial condition of the borrower. Reflecting the Bank's business region, at June 30, 2016, approximately 31% of the commercial real estate mortgage portfolio was represented by loans to the lodging industry. The Bank underwrites lodging industry loans as operating businesses, lending primarily to seasoned establishments with stabilized cash flows.

Commercial and Industrial Loans: Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably, and prudently expand its business. Commercial and industrial loans are primarily made in the Bank's market areas and are underwritten on the basis of the borrower's ability to service the debt from income. These loans typically have variable interest rates

and amortize over a period of less than 10 years. As a general practice, the Bank takes as collateral a lien on available real estate, equipment or other assets owned by the borrower and obtains a personal guaranty of the borrower(s) or principal(s). Working capital loans are primarily collateralized by short-term assets whereas term loans are primarily collateralized by long-term assets. The risk in commercial and industrial loans is principally due to the type of collateral securing these loans. The increased risk also derives from the expectation that commercial and industrial loans generally will be serviced principally from the operations of the business, and, if not successful, these loans are primarily secured by tangible, non-real estate collateral.

Construction and Land Development Loans: The Bank makes loans to finance the construction of residential and non-residential properties. Construction loans generally are collateralized by first liens on real estate with terms of six to twenty-four months. The Bank conducts periodic inspections, either directly or through an agent, prior to approval of periodic draws on these loans. Underwriting guidelines similar to those described immediately above are also used in the Bank's construction lending activities. Construction loans involve additional risks attributable to the fact that loan funds are advanced against a project under construction and the project is of uncertain value prior to its completion. Because of uncertainties inherent in estimating construction costs, the market value of the completed project and the effects of governmental regulation on real property, it can be difficult to accurately evaluate the total funds required to complete a project and the related loan to value ratio. As a result of these uncertainties, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. In many cases the success of the project can also depend upon the financial support/strength of the sponsorship. If the Bank is forced to foreclose on a project prior to completion, there is no assurance that the Bank will be able to recover the entire unpaid portion of the loan. In addition, the Bank may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. While the Bank has underwriting procedures designed to identify what it believes to be acceptable levels of risks in construction lending, no assurance can be given that these procedures will prevent losses from the risks described above.

Residential Real Estate Mortgage Loans: The Bank originates and purchases first-lien, adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of residential property. These loans are principally collateralized by owner-occupied properties, and to a lesser extent second homes and vacation properties, and are amortized over 10 to 30 years. From time-to-time the Bank will sell longer-term, low rate, residential mortgage loans to the Federal Home Loan Mortgage Corporation ( FHLMC ) with servicing rights retained. This practice allows the Bank to better manage interest rate risk and liquidity risk. In an effort to manage risk of loss and strengthen secondary market liquidity opportunities, management typically uses secondary market underwriting, appraisal, and servicing guidelines for all loans, including those held in its portfolio. Loans on one-to-four-family residential real estate are mostly originated in amounts of no more than 80% of appraised value or have private mortgage insurance. Mortgage title insurance and hazard insurance is required.

Home Equity Loans: The Bank originates home equity lines of credit and second mortgage loans (loans which are secured by a junior lien position on one-to-four-family residential real estate). Home equity loans are mostly

originated in amounts of no more than 85% of the combined loan-to-value ratio (first and second liens), or have private mortgage insurance. These loans carry a higher risk than first mortgage residential loans as they are in a second position relating to collateral. Risk is reduced through underwriting criteria, which include credit verification, appraisals and evaluations, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate.

**Non-performing Loans:** The following table sets forth information regarding non-accruing loans and accruing loans 90 days or more overdue at June 30, 2016, and December 31, 2015.

### TOTAL NON-PERFORMING LOANS

|   | June 30, | December 31, |
|---|----------|--------------|
|   | 2016     | 2015         |
| Commercial real estate mortgages                      | \$1,087  | \$1,279      |
| Commercial and industrial loans                       | 190      | 292          |
| Commercial construction and land development          | 813      | 1,111        |
| Agricultural and other loans to farmers               | ---      | 16           |
| Total commercial loans                                | 2,090    | 2,698        |
| Residential real estate mortgages                     | 3,157    | 3,452        |
| Home equity loans                                     | 134      | 820          |
| Other consumer loans                                  | 91       | 10           |
| Total consumer loans                                  | 3,382    | 4,282        |
| Total non-accrual loans                               | 5,472    | 6,980        |
| Accruing loans contractually past due 90 days or more | 81       | 28           |
| Total non-performing loans                            | \$5,553  | \$7,008      |

**Troubled Debt Restructures:** A Troubled Debt Restructure ( TDR ) results from a modification of a loan to a borrower who is experiencing financial difficulty in which the Bank grants a concession to the debtor that it would not otherwise consider but for the debtor's financial difficulties. Financial difficulty arises when a debtor is bankrupt or contractually past due, or is likely to become so, based upon its ability to pay. A concession represents an accommodation not generally available to other customers, which may include a below-market interest rate, deferment of principal payments, extension of maturity dates, etc. Such accommodations extended to customers who are not experiencing financial difficulty do not result in TDR classification.

Troubled debt restructurings and related delinquency trends in general are considered in management's evaluation of the allowance for loan losses and the related determination of the provision for loan losses.

Summary information pertaining to the TDRs that occurred during the three and six months ended June 30, 2016 and 2015 follows:



|   | For the Three Months Ended<br>June 30, 2016 |                                       |                                       | For the Six Months Ended<br>June 30, 2016 |                                       |                                       |
|---|---|---------------------------------------|---------------------------------------|---|---------------------------------------|---------------------------------------|
|   | Number<br>of Loans                          | Pre-Modification                      | Post-Modification                     | Number<br>of Loans                        | Pre-Modification                      | Post-Modification                     |
|   |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
| Commercial real estate mortgages        | 1   | \$30                                  | \$30                                  | 3   | \$ 425                                | \$ 418                                |
| Agricultural and other loans to farmers | ---   | ---                                   | ---                                   | 2   | 30                                    | 25                                    |
| <b>Total commercial loans</b>           | 1   | 30                                    | 30                                    | 5   | 455                                   | 443                                   |
| <b>Total</b>                            | 1   | \$30                                  | \$30                                  | 5   | \$ 455                                | \$ 443                                |

|   | For the Three Months Ended<br>June 30, 2015 |                                       |                                       | For the Six Months Ended<br>June 30, 2015 |                                       |                                       |
|---|---|---------------------------------------|---------------------------------------|---|---------------------------------------|---------------------------------------|
|   | Number<br>of Loans                          | Pre-Modification                      | Post-Modification                     | Number<br>of Loans                        | Pre-Modification                      | Post-Modification                     |
|   |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |   | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
| Agricultural and other loans to farmers | ---   | \$---                                 | \$---                                 | 1   | \$ 18                                 | \$ 17                                 |
| <b>Total commercial loans</b>           | ---   | ---                                   | ---                                   | 1   | 18                                    | 17                                    |
| Residential real estate mortgages       | 2   | \$795                                 | \$794                                 | 3   | \$1,267                               | \$1,266                               |
| <b>Total consumer loans</b>             | 2   | 795                                   | 794                                   | 3   | 1,267                                 | 1,266                                 |
| <b>Total</b>                            | 2   | \$795                                 | \$794                                 | 4   | \$1,285                               | \$1,283                               |

The following tables show the Bank's post-modification balance of TDRs listed by type of modification for TDRs that occurred during the three and six months ended June 30, 2016 and 2015:

| June 30, 2016            |                     | June 30, 2015            |                     |
|--------------------------|---------------------|--------------------------|---------------------|
| Three<br>Months<br>Ended | Six Months<br>Ended | Three<br>Months<br>Ended | Six Months<br>Ended |



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|  |       |        |        |         |
|--|-------|--------|--------|---------|
| Extended maturity and adjusted interest rate | \$--- | \$ --- | \$ --- | \$ 489  |
| Extended maturity and adjusted payment       | ---   | 413    | ---    | ---     |
| Adjusted payment                             | ---   | ---    | 607    | 607     |
| Adjusted payment and capitalized interest    | ---   | ---    | 187    | 187     |
| Other concessions                            | 30    | 30     | ---    | ---     |
| Total  | \$30  | \$443  | \$794  | \$1,283 |

As of June 30, 2016, the Bank had \$3,387 of loans outstanding to 21 relationships that were classified as TDRs. These loans consisted of ten commercial real estate loans, eight real estate secured loans, four commercial and industrial loans, four agricultural loans, and one other consumer loan. At June 30, 2016, six of these TDRs totaling \$879 were classified as non-accrual, and none were past due 30 days or more and still accruing.

As of December 31, 2015, the Bank had \$3,162 of loans outstanding to 17 relationships that were classified as TDRs. These loans consisted of seven commercial real estate loans, eight real estate secured loans, four commercial and industrial loans, two agricultural loans, and one other consumer loan. At December 31, 2015, six of these TDRs totaling \$826 were classified as non-accrual, and none were past due 30 days or more and still accruing.

During the six months ended June 30, 2016, one CRE loan for \$40 that had been modified as a TDR within the previous twelve months defaulted, compared with none during the same period in 2015. A default for purposes of this disclosure is a TDR in which the borrower is 90 days or more past due or results in foreclosure and repossession of the applicable collateral.

**Past due loans:** Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. The following tables set forth information regarding past due loans at June 30, 2016 and December 31, 2015. Amounts shown exclude deferred loan origination fees and costs.

| June 30, 2016             | 30-59    | 60-89    | 90 Days | Total    | Current | Total      | Non-Accrual | >90 Days<br>Past Due<br>and<br>Accruing |
|---------------------------|----------|----------|---------|----------|---------|------------|-------------|---|
|                           | Days     | Days     | or      |          |         |            |             |   |
|                           | Past Due | Past Due | Greater | Past Due |         | Loans      |             |   |
| Commercial real           |          |          |         |          |         |            |             |   |
| estate mortgages          | \$ 844   | \$ 103   | \$ 333  | \$1,280  | 388,753 | \$ 390,033 | \$1,087     | \$---                                   |
| Commercial and industrial | 4        | 30       | 190     | 224      | 80,525  | 80,749     | 190         | ---                                     |
| Commercial construction   | ---      | ---      | 813     | 813      | 24,654  | 25,467     | 813         | ---                                     |

and land  
development  
Agricultural and other

|                      |         |        |         |         |             |             |         |      |
|----------------------|---------|--------|---------|---------|-------------|-------------|---------|------|
| loans to farmers     | 13      | ---    | 81      | 94      | 32,987      | 33,081      | ---     | 81   |
| Residential real     |         |        |         |         |             |             |         |      |
| estate mortgages     | 1,488   | 753    | 991     | 3,232   | 443,701     | 446,933     | 3,157   | ---  |
| Home equity          | 31      | 15     | 10      | 56      | 49,274      | 49,330      | 134     | ---  |
| Other consumer loans | 34      | 1      | 2       | 37      | 6,909       | 6,946       | 91      | ---  |
| Tax exempt           | ---     | ---    | ---     | ---     | 16,352      | 16,352      | ---     | ---  |
| Total                | \$2,414 | \$ 902 | \$2,420 | \$5,736 | \$1,043,155 | \$1,048,891 | \$5,472 | \$81 |

|                              | 30-59<br>Days | 60-89<br>Days | 90 Days<br>or<br>Greater | Total<br>Past Due | Current    | Total<br>Loans | Non-<br>Accrual | >90 Days<br>Past Due<br>and<br>Accruing |
|------------------------------|---------------|---------------|--------------------------|-------------------|------------|----------------|-----------------|---|
| <b>December 31, 2015</b>     |               |               |                          |                   |            |                |                 |   |
| Commercial real              |               |               |                          |                   |            |                |                 |   |
| estate mortgages             | \$ 99         | \$ 287        | \$ 241                   | \$ 627            | \$ 370,375 | \$ 371,002     | \$1,279         | \$---                                   |
| Commercial and<br>industrial | 9             | 1             | 271                      | 281               | 79,630     | 79,911         | 292             | ---                                     |
| Commercial<br>construction   |               |               |                          |                   |            |                |                 |   |
| and land<br>development      | ---           | ---           | 1,111                    | 1,111             | 23,815     | 24,926         | 1,111           | ---                                     |
| Agricultural and other       |               |               |                          |                   |            |                |                 |   |
| loans to farmers             | 12            | 70            | 3                        | 85                | 30,918     | 31,003         | 16              | 3                                       |
| Residential real             |               |               |                          |                   |            |                |                 |   |
| estate mortgages             | 1,313         | 452           | 1,299                    | 3,064             | 403,588    | 406,652        | 3,452           | 25                                      |
| Home equity                  | 245           | ---           | 797                      | 1,042             | 50,488     | 51,530         | 820             | ---                                     |
| Other consumer loans         | 66            | ---           | ---                      | 66                | 9,632      | 9,698          | 10              | ---                                     |
| Tax exempt                   | ---           | ---           | ---                      | ---               | 15,244     | 15,244         | ---             | ---                                     |
| Total                        | \$1,744       | \$ 810        | \$3,722                  | \$6,276           | \$ 983,690 | \$ 989,966     | \$6,980         | \$28                                    |

**Impaired Loans:** Impaired loans are all commercial loans for which the Company believes it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement, as well as all loans modified into a TDR, if any. Allowances for losses on impaired loans are determined by the lower of the present value of the expected cash flows related to the loan, using the original contractual interest rate, and its recorded value, or in the case of collateral dependent loans, the lower of the fair value of the collateral, less estimated costs to dispose, and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral less estimated cost to sell.

Details of impaired loans as of June 30, 2016 and December 31, 2015 follows:

|  | June 30, 2016       |                          |                   | December 31, 2015   |                          |                   |
|--|---------------------|--------------------------|-------------------|---------------------|--------------------------|-------------------|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| <b>With no related allowance:</b>            |                     |                          |                   |                     |                          |                   |
| Commercial real estate mortgages             | \$1,900             | \$1,900                  | \$---             | \$1,692             | \$1,736                  | \$---             |
| Commercial and industrial                    | 89                  | 89                       | ---               | 202                 | 352                      | ---               |
| Commercial construction and land development | ---                 | ---                      | ---               | ---                 | ---                      | ---               |
| Agricultural and other loans to farmers      | 127                 | 127                      | ---               | 106                 | 106                      | ---               |
| Residential real estate loans                | 1,214               | 1,330                    | ---               | 1,332               | 1,362                    | ---               |
| Home equity loans                            | 17                  | 17                       | ---               | 18                  | 18                       | ---               |
| Other consumer                               | ---                 | ---                      | ---               | ---                 | ---                      | ---               |
| Subtotal                                     | \$3,347             | \$3,463                  | \$---             | \$3,350             | \$3,574                  | \$---             |
| <b>With an allowance:</b>                    |                     |                          |                   |                     |                          |                   |
| Commercial real estate mortgages             | \$ 536              | \$ 536                   | \$ 43             | \$ 531              | \$ 531                   | \$ 43             |
| Commercial and industrial                    | 220                 | 370                      | 175               | 224                 | 374                      | 175               |
| Commercial construction and land development | 813                 | 2,738                    | 60                | 1,111               | 3,036                    | 58                |
| Agricultural and other loans to farmers      | ---                 | ---                      | ---               | ---                 | ---                      | ---               |
| Residential real estate loans                | 512                 | 628                      | 92                | 515                 | 515                      | 97                |
| Home equity loans                            | ---                 | ---                      | ---               | ---                 | ---                      | ---               |
| Other consumer                               | 7                   | 7                        | ---               | 8                   | 8                        | ---               |
| Subtotal                                     | \$2,088             | \$4,279                  | \$370             | \$2,389             | \$4,464                  | \$373             |
| Total  | \$5,435             | \$7,742                  | \$370             | \$5,739             | \$8,038                  | \$373             |

Details of impaired loans for the three and six months ended June 30, 2016 and 2015 follows:

|                                   | June 30, 2016               |                           |                             |                           | June 30, 2015               |                           |                             |                           |
|-----------------------------------|-----------------------------|---------------------------|-----------------------------|---------------------------|-----------------------------|---------------------------|-----------------------------|---------------------------|
|                                   | Three Months Ended          |                           | Six Months Ended            |                           | Three Months Ended          |                           | Six Months Ended            |                           |
|                                   | Average Recorded Investment | Average Interest Recorded | Average Recorded Investment | Average Interest Recorded | Average Recorded Investment | Average Interest Recorded | Average Recorded Investment | Average Interest Recorded |
| <b>With no related allowance:</b> |                             |                           |                             |                           |                             |                           |                             |                           |
| Commercial real                   | \$1,850                     | \$32                      | \$1,859                     | \$ 53                     | \$2,413                     | \$ 7                      | \$2,698                     | \$14                      |

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|                           |         |       |         |       |         |       |         |       |
|---------------------------|---------|-------|---------|-------|---------|-------|---------|-------|
| estate mortgages          |         |       |         |       |         |       |         |       |
| Commercial and industrial | 92      | 2     | 94      | 4     | 441     | 3     | 446     | 5     |
| Commercial construction   |         |       |         |       |         |       |         |       |
| And land development      | ---     | ---   | ---     | ---   | 1,260   | ---   | 1,260   | ---   |
| Agricultural and other    |         |       |         |       |         |       |         |       |
| loans to farmers          | 128     | 3     | 135     | 5     | 113     | 2     | 118     | 4     |
| Residential real          |         |       |         |       |         |       |         |       |
| estate mortgages          | 1,214   | 17    | 1,146   | 38    | 1,498   | 13    | 1,483   | 25    |
| Home equity loans         | 16      | ---   | 17      | 1     | 18      | ---   | 19      | 1     |
| Other consumer            | ---     | ---   | ---     | ---   | ---     | ---   | ---     | ---   |
| Subtotal                  | \$3,300 | \$54  | \$3,251 | \$101 | \$5,743 | \$25  | \$6,024 | \$49  |
| <b>With an allowance:</b> |         |       |         |       |         |       |         |       |
| Commercial real           |         |       |         |       |         |       |         |       |
| estate mortgages          | \$ 482  | \$--- | \$ 443  | \$--- | \$ 955  | \$--- | \$ 955  | \$--- |
| Commercial and industrial | 221     | ---   | 222     | ---   | 170     | ---   | 170     | ---   |
| Commercial construction   |         |       |         |       |         |       |         |       |
| and land development      | 865     | ---   | 988     | ---   | ---     | ---   | ---     | ---   |
| Agricultural and other    |         |       |         |       |         |       |         |       |
| loans to farmers          | ---     | ---   | ---     | ---   | 54      | ---   | 54      | ---   |
| Residential real          |         |       |         |       |         |       |         |       |
| estate mortgages          | 513     | ---   | 514     | ---   | 184     | ---   | 183     | ---   |
| Home equity loans         | ---     | ---   | ---     | ---   | ---     | ---   | ---     | ---   |
| Other consumer            | 7       | ---   | 8       | ---   | 10      | ---   | 10      | ---   |
| Subtotal                  | \$2,088 | \$--- | \$2,175 | \$--- | \$1,373 | \$--- | \$1,372 | \$--- |
| Total                     | \$5,388 | \$54  | \$5,426 | \$101 | \$7,116 | \$25  | \$7,396 | \$49  |

***Credit Quality Indicators/Classified Loans:*** In monitoring the credit quality of the portfolio, management applies a credit quality indicator to all categories of commercial loans. These credit quality indicators range from one through nine, with a higher number correlating to increasing risk of loss. These ratings are used as inputs to the calculation of the allowance for loan losses.

Consistent with regulatory guidelines, the Bank provides for the classification of loans which are considered to be of lesser quality as substandard, doubtful, or loss (7, 8 and 9, respectively). The Bank considers a loan substandard if it is inadequately protected by the current net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness that jeopardizes liquidation of the debt. Substandard loans include those loans where there is the distinct possibility of some loss of principal, if the deficiencies are not corrected.

Loans that the Bank classifies as doubtful have all of the weaknesses inherent in those loans that are classified as substandard but also have the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is high but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as loss is deferred until its more exact status is determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans. The entire amount of the loan might not be classified as doubtful when collection of a specific portion appears highly probable. Loans are generally not classified doubtful for an extended period of time (i.e., over one year).

Loans that the Bank classifies as losses are those considered uncollectible and of such little value that their continuance as an asset is not warranted and the uncollectible amounts are charged-off. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this worthless asset even though partial recovery may be affected in the future. Losses are taken in the period in which they are determined to be uncollectible.

Loans that do not expose the Bank to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses, are designated as other assets especially mentioned special mention. A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. This might include loans which the lending officer may be unable to supervise properly because of: (i) lack of expertise, inadequate loan agreement; (ii) the poor condition of or lack of control over collateral; (iii) failure to obtain proper documentation or any other deviations from prudent lending practices. Economic or market conditions which may, in the future, affect the obligor may warrant special mention of the asset. Loans for which an adverse trend in the borrower's operations or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized may be included in this classification. Special mention loans are not adversely classified and do not expose an institution to sufficient risks to warrant classification.

The following tables summarize the commercial loan portfolio as of June 30, 2016, and December 31, 2015, by credit quality indicator. Credit quality indicators are reassessed for each applicable commercial loan at least annually, or upon receipt and analysis of the borrower's financial statements, when applicable. Consumer loans, which principally consist of residential mortgage loans, are not rated, but are evaluated for credit quality after origination based on delinquency status (see past due loan aging table above).

|                         | <b>Commercial<br/>real estate<br/>mortgages</b> | <b>Commercial<br/>and industrial</b> | <b>Commercial<br/>construction<br/>and land<br/>development</b> | <b>Agricultural<br/>and other<br/>loans to<br/>farmers</b> | <b>Total</b>     |
|-------------------------|---|--------------------------------------|---|--|------------------|
| <b>June 30, 2016</b>    |   |                                      |   |  |                  |
| Pass                    | \$364,130                                       | \$76,628                             | \$24,654  | \$32,507   | \$497,919        |
| Other Assets Especially |   |                                      |   |  |                  |
| Mentioned               | 10,381  | 1,838                                | ---   | 289  | 12,508           |
| Substandard             | 15,509  | 2,281                                | 813   | 285  | 18,888           |
| Doubtful                | ---   | ---                                  | ---   | ---  | ---              |
| Loss                    | 13  | 2                                    | ---   | ---  | 15               |
| <b>Total</b>            | <b>\$390,033</b>                                | <b>\$80,749</b>                      | <b>\$25,467</b>   | <b>\$33,081</b>  | <b>\$529,330</b> |

| <b>December 31, 2015</b> | <b>Commercial<br/>real estate<br/>mortgages</b> | <b>Commercial<br/>and industrial</b> | <b>Commercial<br/>construction<br/>and land<br/>development</b> | <b>Agricultural<br/>and other<br/>loans to<br/>farmers</b> | <b>Total</b> |
|--------------------------|---|--------------------------------------|---|--|--------------|
| Pass                     | \$345,197                                       | \$74,771                             | \$23,460  | \$30,688   | \$474,116    |
| Other Assets Especially  |   |                                      |   |  |              |
| Mentioned                | 7,381   | 2,349                                | 355   | 168  | 10,253       |
| Substandard              | 18,424  | 2,790                                | 1,111   | 147  | 22,472       |
| Doubtful                 | ---   | ---                                  | ---   | ---  | ---          |
| Loss                     | ---   | 1                                    | ---   | ---  | 1            |
| Total                    | \$371,002                                       | \$79,911                             | \$24,926  | \$31,003   | \$506,842    |

**Allowance for Loan Losses:** The allowance for loan losses (the allowance) is a reserve established through a provision for loan losses (the provision) charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to provide for estimated loan losses and risks inherent in the loan portfolio. The Bank's allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, homogeneous risk pools and specific loss allocations, with qualitative factor adjustments for current events and conditions. The allowance calculation also includes an estimated adjustment for a Loss Emergence Period, which improves the Bank's ability to more accurately forecast probable losses that may exist in the loan portfolio that have not yet emerged into problem loan status. The Bank's process for determining the appropriate level of the allowance is designed to account for credit deterioration as it occurs. The provision reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans, net charge-offs or recoveries, and the overall size of the loan portfolio, among other factors. The provision also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance also reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Bank's control, including, among other things, the performance of the Bank's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Bank's allowance for loan losses consists of two principal elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) general valuation allowances, determined by taking historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, for economic conditions and other qualitative risk factors both internal and external to the Bank.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship level for all commercial loans. When a loan has a classification of substandard or worse and is non-accruing, or considered a Troubled Debt Restructure (regardless of accrual status or risk rating). The Bank analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts contractually owed and collateral deficiencies, among other observable considerations.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off, and is the first step to determining the general allowance component of the reserve. The Bank calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual net charge-offs experienced to the total loan balance in the pool. The



historical loss ratios are updated quarterly based on this net charge-off experience. A historical valuation allowance is established for each pool of similar

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loans based upon the product of the historical loss rate and the total dollar amount of the loans in the pool, net of any loans for which reserves are already established. The Bank's pools of similar loans include similarly risk-graded groups of commercial real estate loans, commercial and industrial loans, commercial construction and development loans, municipal loans, residential mortgage loans, consumer revolving loans, and consumer installment loans.

The general valuation allowance is determined by making adjustments to the historical valuation allowances (above), where adjustments are based on general economic conditions and other qualitative risk factors both internal and external to the Bank. Such qualitative factor adjustments are determined by evaluating, among other things: (i) changes in lending policies and procedures; (ii) economic and business conditions; (iii) changes in the volume and nature of the loan portfolio; (iv) experience, ability and depth of lending management and staff; (v) changes in asset quality and problem loan trends; (vi) quality of internal controls and effectiveness of loan review; (vii) concentrations of credit; (viii) external factors, including changes in competition, legal, and regulatory matters; and (ix) real estate market conditions and valuations of collateral. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. The results are then used to determine an appropriate general valuation allowance.

Once established, the general valuation allowance is then modified by the Loss Emergence Period established for each pool of homogeneous loans.

Loans identified as losses by management, external loan review and/or bank examiners, are charged-off. Furthermore, consumer loan accounts are charged-off based on regulatory requirements.

The following tables detail activity in the allowance for loan losses by portfolio segment for the three and six months ended June 30, 2016, and 2015 and twelve months ended December 31, 2015. The tables also provide details regarding the Bank's recorded investment in loans related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Bank's impairment methodology. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

|                      |                    | <b>Commercial<br/>Commercial Construction</b> |                    |                     |                    |                 |               |            |              |  |
|----------------------|--------------------|---|--------------------|---------------------|--------------------|-----------------|---------------|------------|--------------|--|
| <b>Three Months</b>  |                    |   |                    |                     |                    |                 |               |            |              |  |
| <b>Ended</b>         | <b>Commercial</b>  | <b>and</b>                                    | <b>and land</b>    | <b>Residential</b>  |                    | <b>Home</b>     |               |            |              |  |
| <b>June 30, 2016</b> | <b>Real Estate</b> | <b>Industrial</b>                             | <b>development</b> | <b>Agricultural</b> | <b>Real Estate</b> | <b>Consumer</b> | <b>Equity</b> | <b>Tax</b> | <b>Total</b> |  |
|                      | \$4,667            | \$1,233                                       | \$ 231             | \$ 365              | \$ 2,621           | \$ 108          | \$ 539        | \$ 50      | \$ 9,814     |  |

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|                   |         |         |        |        |          |        |        |       |          |  |
|-------------------|---------|---------|--------|--------|----------|--------|--------|-------|----------|--|
| Beginning Balance |         |         |        |        |          |        |        |       |          |  |
| Charged Off       | ---     | (1)     | ---    | ---    | (91)     | (7)    | ---    | ---   | (99)     |  |
| Recoveries        | 7       | 3       | ---    | ---    | 8        | 7      | 1      | ---   | 26       |  |
| Provision         | (9)     | 32      | (36)   | 18     | 145      | (8)    | 7      | 1     | 150      |  |
| Ending Balance    | \$4,665 | \$1,267 | \$ 195 | \$ 383 | \$ 2,683 | \$ 100 | \$ 547 | \$ 51 | \$ 9,891 |  |

| Six Months Ended June 30, 2016 | Commercial             |                           |                                 |              |                         |          |             |            | Total    |
|--------------------------------|------------------------|---------------------------|---------------------------------|--------------|-------------------------|----------|-------------|------------|----------|
|                                | Commercial Real Estate | Commercial and Industrial | Commercial and land development | Agricultural | Residential Real Estate | Consumer | Home Equity | Tax Exempt |          |
| Beginning Balance              | \$4,246                | \$1,236                   | \$ 184                          | \$ 307       | \$ 2,747                | \$ 111   | \$ 561      | \$ 47      | \$ 9,439 |
| Charged Off                    | (34)                   | (90)                      | ---                             | ---          | (122)                   | (17)     | ---         | ---        | (263)    |
| Recoveries                     | 13                     | 4                         | ---                             | 40           | 28                      | 13       | 2           | ---        | 100      |
| Provision                      | 440                    | 117                       | 11                              | 36           | 30                      | (7)      | (16)        | 4          | 615      |
| Ending Balance                 | \$4,665                | \$1,267                   | \$ 195                          | \$ 383       | \$ 2,683                | \$ 100   | \$ 547      | \$ 51      | \$ 9,891 |

of which:

Amount for loans

individually evaluated for

|            |       |        |       |        |       |       |        |        |        |
|------------|-------|--------|-------|--------|-------|-------|--------|--------|--------|
| impairment | \$ 43 | \$ 175 | \$ 60 | \$ --- | \$ 54 | \$ 38 | \$ --- | \$ --- | \$ 370 |
|------------|-------|--------|-------|--------|-------|-------|--------|--------|--------|

Amount for loans

collectively evaluated for

|            |         |         |        |        |          |       |        |       |          |
|------------|---------|---------|--------|--------|----------|-------|--------|-------|----------|
| impairment | \$4,622 | \$1,092 | \$ 135 | \$ 383 | \$ 2,629 | \$ 62 | \$ 547 | \$ 51 | \$ 9,521 |
|------------|---------|---------|--------|--------|----------|-------|--------|-------|----------|

Loans individually

Evaluated for

|            |         |        |        |        |          |      |        |        |          |
|------------|---------|--------|--------|--------|----------|------|--------|--------|----------|
| impairment | \$2,436 | \$ 309 | \$ 813 | \$ 127 | \$ 1,540 | \$ 7 | \$ 203 | \$ --- | \$ 5,435 |
|------------|---------|--------|--------|--------|----------|------|--------|--------|----------|

Loans  
collectively

Evaluated  
for

impairment \$387,597    \$80,440    \$ 24,654    \$ 32,954    \$ 445,393    \$ 6,939    \$49,127    \$16,352    \$1,043,456

| Three Months<br>Ended | Commercial Construction |                           |                   |                         |              |                            |          |                | Total    |               |
|-----------------------|-------------------------|---------------------------|-------------------|-------------------------|--------------|----------------------------|----------|----------------|----------|---------------|
|                       | June<br>30, 2015        | Commercial<br>Real Estate | and<br>Industrial | and land<br>development | Agricultural | Residential<br>Real Estate | Consumer | Home<br>Equity |          | Tax<br>Exempt |
| Beginning             |                         |                           |                   |                         |              |                            |          |                |          |               |
| Balance               | \$ 4,500                | \$ 1,074                  | \$ 107            | \$ 334                  | 2,875        | \$ 145                     | \$ 367   | \$ 76          | \$ 9,478 |               |
| Charged Off           | (181)                   | (213)                     | ---               | ---                     | (70)         | (14)                       | (311)    | ---            | (789)    |               |
| Recoveries            | 5                       | 1                         | ---               | ---                     | ---          | 4                          | ---      | ---            | 10       |               |
| Provision             | (35)                    | 285                       | 38                | 38                      | (320)        | (25)                       | 416      | 3              | 400      |               |
| Ending                |                         |                           |                   |                         |              |                            |          |                |          |               |
| Balance               | \$ 4,289                | \$ 1,147                  | \$ 145            | \$ 372                  | \$ 2,485     | \$ 110                     | \$ 472   | \$ 79          | \$ 9,099 |               |

| Six Months<br>Ended June<br>30, 2015 | Commercial                |                                 |   |              | Residential    |          | Home<br>Equity | Tax<br>Exempt | Total    |
|--------------------------------------|---------------------------|---------------------------------|---|--------------|----------------|----------|----------------|---------------|----------|
|                                      | Commercial<br>Real Estate | Commercial<br>and<br>Industrial | Construction<br>and land<br>development | Agricultural | Real<br>Estate | Consumer |                |               |          |
| Beginning                            |                           |                                 |   |              |                |          |                |               |          |
| Balance                              | \$ 4,468                  | \$ 929                          | \$ 145                                  | \$ 277       | \$ 2,714       | \$ 94    | \$ 271         | \$ 71         | \$ 8,969 |
| Charged Off                          | (206)                     | (288)                           | ---                                     | (18)         | (70)           | (25)     | (351)          | ---           | (958)    |
| Recoveries                           | 39                        | 2                               | ---                                     | 12           | 129            | 11       | ---            | ---           | 193      |
| Provision                            | (12)                      | 504                             | ---                                     | 101          | (288)          | 30       | 552            | 8             | 895      |
| Ending                               |                           |                                 |   |              |                |          |                |               |          |
| Balance                              | \$ 4,289                  | \$ 1,147                        | \$ 145                                  | \$ 372       | \$ 2,485       | \$ 110   | \$ 472         | \$ 79         | \$ 9,099 |

of which:

Amount for  
loans

individually  
evaluated  
for

|            |        |        |        |       |       |        |      |      |        |
|------------|--------|--------|--------|-------|-------|--------|------|------|--------|
| impairment | \$ 419 | \$ 169 | \$ --- | \$ 47 | \$ 40 | \$ --- | \$ 1 | \$ - | \$ 676 |
|------------|--------|--------|--------|-------|-------|--------|------|------|--------|

Amount for  
loans

collectively  
evaluated  
for

|            |         |        |        |        |          |        |        |       |          |
|------------|---------|--------|--------|--------|----------|--------|--------|-------|----------|
| impairment | \$3,870 | \$ 978 | \$ 145 | \$ 325 | \$ 2,445 | \$ 110 | \$ 471 | \$ 79 | \$ 8,423 |
|------------|---------|--------|--------|--------|----------|--------|--------|-------|----------|

Loans  
individually

evaluated  
for

|            |         |        |          |        |          |      |        |        |          |
|------------|---------|--------|----------|--------|----------|------|--------|--------|----------|
| impairment | \$2,992 | \$ 469 | \$ 1,260 | \$ 166 | \$ 1,180 | \$ 9 | \$ --- | \$ --- | \$ 6,076 |
|------------|---------|--------|----------|--------|----------|------|--------|--------|----------|

Loans  
collectively

Evaluated  
for

|            |           |  |           |  |           |          |          |           |
|------------|-----------|--|-----------|--|-----------|----------|----------|-----------|
| impairment | \$351,137 |  | \$ 33,160 |  | \$ 11,132 | \$51,794 | \$16,146 | \$977,045 |
|------------|-----------|--|-----------|--|-----------|----------|----------|-----------|

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\$ 87,733                      \$ 33,368                      \$ 392,575

| Twelve<br>Months<br>Ended | Commercial<br>Commercial Construction<br>and<br>Residential<br>Real Estate |            |                         |              |          |          |                |        | Tax      | Total |
|---------------------------|--|------------|-------------------------|--------------|----------|----------|----------------|--------|----------|-------|
| December<br>31, 2015      | Commercial<br>Real Estate  | Industrial | and land<br>development | Agricultural | Estate   | Consumer | Home<br>Equity | Exempt |          |       |
| Beginning                 |  |            |                         |              |          |          |                |        |          |       |
| Balance                   | \$ 4,468   | \$ 929     | \$ 145                  | \$ 277       | \$ 2,714 | \$ 94    | \$ 271         | \$ 71  | \$ 8,969 |       |
| Charged Off               | (667)  | (323)      | ----                    | (72)         | (70)     | (111)    | (376)          | ---    | (1,619)  |       |
| Recoveries                | 98   | 36         | ----                    | 18           | 129      | 22       | 1              | ---    | 304      |       |
| Provision                 | 347  | 594        | 39                      | 84           | (26)     | 106      | 665            | (24)   | 1,785    |       |
| Ending                    |  |            |                         |              |          |          |                |        |          |       |
| Balance                   | \$ 4,246   | \$ 1,236   | \$ 184                  | \$ 307       | \$ 2,747 | \$ 111   | \$ 561         | \$ 47  | \$ 9,439 |       |

of which:

Amount for  
loans

individually  
evaluated

|                   |       |        |       |        |       |        |        |        |        |
|-------------------|-------|--------|-------|--------|-------|--------|--------|--------|--------|
| for<br>impairment | \$ 43 | \$ 175 | \$ 58 | \$ --- | \$ 97 | \$ --- | \$ --- | \$ --- | \$ 373 |
|-------------------|-------|--------|-------|--------|-------|--------|--------|--------|--------|

Amount for  
loans

collectively  
evaluated  
for

|            |          |          |        |        |          |        |        |       |          |
|------------|----------|----------|--------|--------|----------|--------|--------|-------|----------|
| impairment | \$ 4,203 | \$ 1,061 | \$ 126 | \$ 307 | \$ 2,650 | \$ 111 | \$ 561 | \$ 47 | \$ 9,066 |
|------------|----------|----------|--------|--------|----------|--------|--------|-------|----------|

Loans  
individually

evaluated  
for

|            |          |        |          |        |          |      |       |        |          |
|------------|----------|--------|----------|--------|----------|------|-------|--------|----------|
| impairment | \$ 2,223 | \$ 426 | \$ 1,111 | \$ 106 | \$ 1,847 | \$ 8 | \$ 18 | \$ --- | \$ 5,739 |
|------------|----------|--------|----------|--------|----------|------|-------|--------|----------|

L o a n s  
collectively

|            |           |          |          |          |           |          |          |          |           |  |
|------------|-----------|----------|----------|----------|-----------|----------|----------|----------|-----------|--|
| evaluated  |           |          |          |          |           |          |          |          |           |  |
| f o r      |           |          |          |          |           |          |          |          |           |  |
| impairment | \$368,779 | \$79,485 | \$23,815 | \$30,897 | \$404,805 | \$ 9,690 | \$51,512 | \$15,244 | \$984,227 |  |

**Loan Concentrations:** Because of the Company’s proximity to Acadia National Park, a large part of the economic activity in the Bank’s area is generated from the hospitality business associated with tourism. At June 30, 2016, and December 31, 2015, loans to the lodging industry amounted to approximately \$123,595 and \$98,231, respectively.

**Note 9: Other Real Estate Owned**

Other real estate owned ( OREO ) is classified in Other Assets on the Company’s balance sheet.

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The Company's OREO activity for the six months ended June 30, 2016 and 2015 are presented below:

|                              | <b>2016</b> | <b>2015</b> |
|------------------------------|-------------|-------------|
| Balance at beginning of year | \$256       | \$523       |
| Additions                    | ---         | ---         |
| Disposals                    | ---         | (110)       |
| Writedowns                   | (47)        | (20)        |
| Balance at end of period     | \$209       | \$393       |

The Company's OREO portfolio by property type is presented in the table below as of June 30, 2016 and December 31, 2015:

|             | <b>2016</b>                 |                       | <b>2015</b>                 |                       |
|-------------|-----------------------------|-----------------------|-----------------------------|-----------------------|
|             | <b>Number of properties</b> | <b>Carrying value</b> | <b>Number of properties</b> | <b>Carrying value</b> |
| Residential | 2                           | \$119                 | 3                           | \$143                 |
| Commercial  | 1                           | 90                    | 2                           | 250                   |
| Total       | 3                           | \$209                 | 5                           | \$393                 |

The Company's net gains and losses on OREO properties are presented within non-interest expense on the consolidated statements of income.

The Company recorded net gains and losses on OREO properties for the three and six months ended June 30, 2016 and 2015 as follows:

|                            | <b>June 30, 2016</b>      |                         | <b>June 30, 2015</b>      |                         |
|----------------------------|---------------------------|-------------------------|---------------------------|-------------------------|
|                            | <b>Three Months Ended</b> | <b>Six Months Ended</b> | <b>Three Months Ended</b> | <b>Six Months Ended</b> |
| Net (losses) gains on OREO | \$(47)                    | \$(47)                  | \$44                      | \$44                    |

At June 30, 2016, the Bank had consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process according to local requirements of the applicable jurisdictions totaling \$2,937 compared with \$4,575 at December 31, 2015.





**Note 10: Reclassifications Out of Accumulated Other Comprehensive Income**

The following table summarizes the reclassifications out of Accumulated Other Comprehensive Income for the six months ended June 30, 2016 and 2015.

| <b>Details about Accumulated<br/>Other Comprehensive Income</b>           | <b>Amount Reclassified from<br/>Accumulated Other<br/>Comprehensive Income</b> |   | <b>Affected Line Item in the<br/>Statement Where Net<br/>Income is Presented</b> |
|---|--|---|--|
|   | <b>Six Months<br/>Ended<br/>June 30,<br/>2016</b>                              | <b>Six Months<br/>Ended<br/>June 30,<br/>2015</b> |  |
| Realized gains and losses on  |  |   |  |
| available-for-sale securities   | \$ 3,135   | \$1,206   | Net securities gains   |
| Tax (expense) or benefit  | (1,097)  | (422)   | Provision for income taxes   |
| Net of tax  | \$ 2,038   | \$ 784  | Net income   |
| Amortization of prior service cost and<br>actuarial loss for supplemental | \$ (14)  | \$ (19)   | Salaries and benefits  |

|                                       |          |         |                            |
|---------------------------------------|----------|---------|----------------------------|
| executive retirement plan             |          |         |                            |
| Tax (expense) or benefit              | 5        | 6       | Provision for income taxes |
| Net of tax                            | \$ (9)   | \$ (13) | Net income                 |
| Total reclassification for the period | \$ 2,029 | \$ 771  |                            |

### Note 11: Financial Derivative Instruments

As part of its overall asset and liability management strategy, the Bank periodically uses derivative instruments to minimize significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The Bank's interest rate risk management strategy involves modifying the re-pricing characteristics of certain assets or liabilities so that changes in interest rates do not have a significant effect on net interest income.

The Company recognizes its derivative instruments on the consolidated balance sheet at fair value. On the date the derivative instrument is entered into, the Bank designates whether the derivative is part of a hedging relationship (i.e., cash flow or fair value hedge). The Bank formally documents relationships between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking hedge transactions. The Bank also assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used in hedging transactions are highly effective in offsetting the changes in cash flows or fair values of hedged items. Changes in fair value of derivative instruments that are highly effective and qualify as cash flow hedges are recorded in other comprehensive income or loss. Any ineffective portion is recorded in earnings. The Bank discontinues hedge accounting when it is determined that the derivative is no longer highly effective in offsetting changes of the hedged risk on the hedged item, or management determines that the designation of the derivative as a hedging instrument is no longer appropriate.

In 2014, interest rate cap agreements were purchased to limit the Bank's exposure to rising interest rates on four rolling, three-month borrowings indexed to three month LIBOR. Under the terms of the agreements, the Bank paid total premiums of \$4,566 for the right to receive cash flow payments if 3-month LIBOR rises above the caps of 3.00%, thus effectively ensuring interest expense on the borrowings at maximum rates of 3.00% for the duration of the agreements. The interest rate cap agreements were designated as cash flow hedges.

At June 30, 2016, the Bank had four outstanding derivative instruments with notional amounts totaling \$90,000. These derivative instruments were interest rate cap agreements. The notional amounts of the financial derivative instruments do not represent exposure to credit loss. The Bank is exposed to credit loss only to the extent the counter-party defaults in its responsibility to pay interest under the terms of the agreements. The credit risk in derivative instruments is mitigated by entering into transactions with highly-rated counterparties that management believes to be creditworthy and by limiting the amount of exposure to each counter-party. At June 30, 2016, the Bank's derivative instrument counterparties were credit rated AA by the major credit rating agencies.

The details of the Bank's financial derivative instruments as of June 30, 2016 are summarized below:

### Interest Rate Cap Agreements

| Notional<br>Amount | Termination<br>Date | 3-Month LIBOR<br>Strike Rate | Premium<br>Paid | Unamortized<br>Premium | Fair<br>Value |
|--------------------|---------------------|------------------------------|-----------------|------------------------|---------------|
| \$25,000           | 06/02/21            | 3.00%                        | \$ 922          | \$ 915                 | \$ 76         |
| \$20,000           | 06/04/24            | 3.00%                        | \$1,470         | \$1,466                | \$284         |
| \$20,000           | 10/21/21            | 3.00%                        | \$ 632          | \$ 631                 | \$ 83         |
| \$25,000           | 10/21/24            | 3.00%                        | \$1,542         | \$1,541                | \$399         |

At June 30, 2016, the total fair value of the interest rate cap agreements was \$842, compared with \$2,069 at December 31, 2015. The fair values of the interest rate cap agreements are included in other assets on the Company's consolidated balance sheets. Changes in the fair value, representing unrealized gains or losses, are recorded in accumulated other comprehensive income, net of tax.

The premiums paid on the interest rate cap agreements are being recognized as increases in interest expense over the duration of the agreements using the caplet method. For the three and six months ended June 30, 2016, \$3 and \$11 of premium amortization was recorded, respectively. During the next twelve months, \$134 of the total premiums will be recognized as increases to interest expense, increasing the interest expense related to the hedged borrowings.

A summary of the hedging related balances as of June 30, 2016 and December 31, 2015 follows:

|   | Gross     | Net of Tax |
|---|-----------|------------|
| <b>June 30, 2016</b>                      |           |            |
| Unrealized loss on interest rate caps     | \$(3,711) | \$(2,412)  |
| Unamortized premium on interest rate caps | 4,553     | 2,959      |

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|       |        |        |
|-------|--------|--------|
| Total | \$ 842 | \$ 547 |
|-------|--------|--------|

**December 31, 2015**

|   |           |           |
|---|-----------|-----------|
| Unrealized loss on interest rate caps     | \$(2,495) | \$(1,621) |
| Unamortized premium on interest rate caps | 4,564     | 2,966     |
| Total                                     | \$ 2,069  | \$ 1,345  |

**Note 12: Retirement Benefit Plans**

The Company has non-qualified supplemental executive retirement agreements with certain retired officers. The agreements provide supplemental retirement benefits payable in installments over a period of years upon retirement or death. The Company recognized the net present value of payments associated with the agreements over the service periods of the participating officers. Interest costs continue to be recognized on the benefit obligations.

The Company also has a supplemental executive retirement agreement with a certain current executive officer. This agreement provides a stream of future payments in accordance with a defined vesting schedule upon retirement, termination, or upon a change of control.

The following tables summarize the net periodic benefit costs for the three and six months ended June 30, 2016, and 2015:

|  | <b>Supplemental Executive Retirement Plans</b> |             |
|--|--|-------------|
| <b>Three Months Ended June 30,</b>                       | <b>2016</b>                                    | <b>2015</b> |
| Service cost   | \$ 18  | \$ 19       |
| Interest cost  | 32   | 31          |
| Actuarial loss on supplemental executive retirement plan | 7  | 8           |
| Net periodic benefit cost                                | \$ 57  | \$ 58       |
| <br>   |  |             |
| <b>Six Months Ended June 30,</b>                         |  |             |
| Service cost   | \$ 36  | \$ 36       |
| Interest cost  | 64   | 62          |
| Actuarial loss on supplemental executive retirement plan | 14   | 19          |
| Net periodic benefit cost                                | \$114  | \$117       |

The Company is expected to recognize \$228 of expense for the foregoing plans for the year ended December 31, 2016. The Company is expected to contribute \$291 to the foregoing plans in 2016. As of June 30, 2016, the Company had contributed \$150.

**Note 13: Commitments and Contingent Liabilities**

The Bank is a party to financial instruments in the normal course of business to meet financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit, and standby letters of credit.

Commitments to originate loans, including unused lines of credit, 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 being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit policy to make such commitments as it uses for on-balance-sheet items, such as loans. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower.

The Bank guarantees the obligations or performance of customers by issuing standby letters of credit to third parties. These standby letters of credit are primarily issued in support of third party debt or obligations. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same credit origination, portfolio maintenance and management procedures in effect to monitor other credit and off-balance sheet instruments. Exposure to credit loss in the event of non-performance by the counter-party to the financial instrument for standby letters of credit is represented by the contractual amount of those instruments.

Typically, these standby letters of credit have terms of five years or less and expire unused; therefore, the total amounts do not necessarily represent future cash requirements.

The following table summarizes the contractual amounts of commitments and contingent liabilities as of June 30, 2016, and December 31, 2015:

|  | <b>June 30,<br/>2016</b> | <b>December 31,<br/>2015</b> |
|--|--------------------------|------------------------------|
| Commitments to originate loans             | \$25,047                 | \$41,529                     |
| Unused lines of credit                     | \$93,974                 | \$97,283                     |
| Un-advanced portions of construction loans | \$24,180                 | \$12,719                     |
| Standby letters of credit                  | \$ 385                   | \$ 385                       |

As of June 30, 2016, and December 31, 2015, the fair value of the standby letters of credit was not significant to the Company's consolidated financial statements.

#### **Note 14: Goodwill and Other Intangible Assets**

**Goodwill:** Goodwill totaled \$4,935 at June 30, 2016, and December 31, 2015. In 2012 the Company recorded \$1,777 of goodwill in connection with the Bank's acquisition of substantially all of the assets and the assumption of certain liabilities including all deposits of the Border Trust Company.

**Core Deposit Intangible Asset:** The Company has a finite-lived intangible asset capitalized on its consolidated balance sheet in the form of a core deposit intangible asset related to the Border Trust Company acquisition. The core deposit intangible is being amortized over an estimated useful life of eight and one-half years and is included in other assets on the Company's consolidated balance sheet. At June 30, 2016, and December 31, 2015, the balance of the core deposit intangible asset amounted to \$424 and \$470, respectively.

|                                | <b>June 30,<br/>2016</b> | <b>December 31,<br/>2015</b> |
|--------------------------------|--------------------------|------------------------------|
| Gross carrying amount          | \$783                    | \$783                        |
| Less: accumulated amortization | 359                      | 313                          |
| Net carrying amount            | \$424                    | \$470                        |



Amortization expense on the finite-lived intangible assets is expected to total \$92 for each year from 2016 through 2020, then \$8 for 2021.

**Note 15: Fair Value Measurements**

The Company measures fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact, and (iv) willing to transact.

The Company's fair value measurements employ valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the servicing capacity of an asset (replacement cost). Valuation techniques are consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The Company uses a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets (Level 1 measurements) for identical assets or liabilities and the lowest priority to unobservable inputs (Level 3 measurements). The fair value hierarchy is as follows:

*Level 1* Valuation is based on unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

*Level 2* Valuation is based on quoted prices for similar instruments in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and model-based techniques for which all significant assumptions are observable in the market.

*Level 3* Valuation is principally generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates that market participants would use in pricing the asset or liability. Valuation techniques include use of discounted cash flow models and similar techniques.

The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The most significant instruments that the Company values are securities, all of which fall into Level 2 in the fair value hierarchy. The securities in the available for sale portfolio are priced by independent providers. In obtaining such valuation information from third parties, the Company has evaluated their valuation methodologies used to develop the fair values in order to determine whether valuations are appropriately placed within the fair value hierarchy and whether the valuations are representative of an exit price in the Company's principal markets. The Company's principal markets for its securities portfolios are the secondary institutional markets, with an exit price that is predominantly reflective of bid level pricing in those markets. Additionally, the Company periodically tests the reasonableness of the prices provided by these third parties by obtaining fair values from other independent providers and by obtaining desk bids from a variety of institutional brokers.

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.

***Securities Available for Sale:*** All securities and major categories of securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from independent pricing providers. The fair value measurements used by the pricing providers consider observable data that may include dealer quotes, market maker quotes and live trading systems. If quoted prices are not readily available, fair values are determined using matrix pricing models, or other model-based valuation techniques requiring observable inputs other than quoted prices such as market pricing spreads, credit information, callable features, cash flows, the U.S. Treasury yield curve,

trade execution data, market consensus prepayment speeds, default rates, and the securities terms and conditions, among other things.

The foregoing valuation methodologies may produce fair value calculations that may not be fully indicative of net realizable value or reflective of future fair values. While Company management believes these valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following tables summarize financial assets and financial liabilities measured at fair value on a recurring basis as of June 30, 2016, and December 31, 2015, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| <b>June 30, 2016</b>                                     | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total Fair<br/>Value</b> |
|--|---------------------------|---------------------------|---------------------------|-----------------------------|
| Securities available for sale:                           |                           |                           |                           |                             |
| Mortgage-backed securities:                              |                           |                           |                           |                             |
| US Government-sponsored enterprises                      | \$ ---                    | \$332,980                 | \$ ---                    | \$332,980                   |
| US Government agencies                                   | \$ ---                    | \$ 82,368                 | \$ ---                    | \$ 82,368                   |
| Private label  | \$ ---                    | \$ 1,327                  | \$ ---                    | \$ 1,327                    |
| Obligations of states and political subdivisions thereof | \$ ---                    | \$115,915                 | \$ ---                    | \$115,915                   |
| Derivative assets  | \$ ---                    | \$ 842                    | \$ ---                    | \$ 842                      |

| <b>December 31, 2015</b>                                 | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Total Fair<br/>Value</b> |
|--|---------------------------|---------------------------|---------------------------|-----------------------------|
| Securities available for sale:                           |                           |                           |                           |                             |
| Mortgage-backed securities:                              |                           |                           |                           |                             |
| US Government-sponsored enterprises                      | \$ ---                    | \$306,993                 | \$ ---                    | \$306,993                   |
| US Government agencies                                   | \$ ---                    | \$ 79,130                 | \$ ---                    | \$ 79,130                   |
| Private label  | \$ ---                    | \$ 3,464                  | \$ ---                    | \$ 3,464                    |
| Obligations of states and political subdivisions thereof | \$ ---                    | \$115,382                 | \$ ---                    | \$115,382                   |
| Derivative assets  | \$ ---                    | \$ 2,069                  | \$ ---                    | \$ 2,069                    |

The following tables present the carrying value of certain financial assets and financial liabilities measured at fair value on a non-recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value.

| <b>As of June 30, 2016</b> | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Fair Value</b> | <b>Loss</b> |
|----------------------------|---------------------------|---------------------------|---------------------------|-------------------|-------------|
|----------------------------|---------------------------|---------------------------|---------------------------|-------------------|-------------|

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|                                     |        |        |         |         |       |
|-------------------------------------|--------|--------|---------|---------|-------|
| Other real estate owned             | \$ --- | \$ --- | \$ 209  | \$ 209  | \$47  |
| Collateral dependent impaired loans | \$ --- | \$ --- | \$2,769 | \$2,769 | \$--- |

| <b>As of December 31, 2015</b>      | <b>Level 1<br/>Inputs</b> | <b>Level 2<br/>Inputs</b> | <b>Level 3<br/>Inputs</b> | <b>Fair Value</b> | <b>Loss</b> |
|-------------------------------------|---------------------------|---------------------------|---------------------------|-------------------|-------------|
| Other real estate owned             | \$ ---                    | \$ ---                    | \$ 256                    | \$ 256            | \$27        |
| Collateral dependent impaired loans | \$ ---                    | \$ ---                    | \$1,999                   | \$1,999           | \$---       |

The Company had total collateral dependent impaired loans with carrying values of \$2,769 and \$1,999 which had specific reserves included in the allowance of \$307 and \$312, at June 30, 2016 and December 31, 2015, respectively. The Company measures the value of collateral dependent impaired loans using Level 3 inputs. Specifically, the Company uses the appraised value of the collateral, which is then discounted for estimated costs to dispose and other considerations. These discounts generally range from 10% to 30% of appraised value.

In estimating the fair value of OREO, the Company generally uses market appraisals less estimated costs to dispose of the property, which generally range from 10% to 30% of appraised value. Management may also make adjustments to reflect estimated fair value declines, or may apply other discounts to appraised values for unobservable factors resulting from its knowledge of the property or consideration of broker quotes. The appraisers use a market, income, and/or a cost approach in determining the value of the collateral. Therefore they have been categorized as a Level 3 measurement.

There were no transfers between levels during the periods presented.

#### **Note 16: Fair Value of Financial Instruments**

The Company discloses fair value information about financial instruments for which it is practicable to estimate fair value. Fair value estimates are made as of a specific point in time based on the characteristics of the financial instruments and relevant market information. Where available, quoted market prices are used. In other cases, fair values are based on estimates using present value or other valuation techniques. These techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial instruments, discount rates, estimates of future cash flows, future expected loss experience and other factors. Changes in assumptions could significantly affect these estimates. Derived fair value estimates cannot be substantiated by comparison to independent markets and, in certain cases, could not be realized in an immediate sale of the instrument.

Fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Accordingly, the aggregate fair value amounts presented do not purport to represent the underlying market value of the Company.

The following describes the methods and significant assumptions used by the Company in estimating the fair values of significant financial instruments:

**Cash and Cash Equivalents:** For cash and cash equivalents, including cash and due from banks and other short-term investments with maturities of 90 days or less, the carrying amounts reported on the consolidated balance sheet approximate fair values.

**Federal Home Loan Bank Stock:** For Federal Home Loan Bank stock, the carrying amounts report on the consolidated balance sheet approximate fair values.

**Loans:** For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

**Deposits:** The fair value of deposits with no stated maturity is equal to the carrying amount. The fair value of time deposits is based on the discounted value of contractual cash flows, applying interest rates currently being offered on wholesale funding products of similar maturities. The fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of alternative forms of funding ( deposit base intangibles ).

**Borrowings:** For borrowings that mature or re-price in 90 days or less, carrying value approximates fair value. The fair value of the Company's remaining borrowings is estimated by using discounted cash flows based on current rates available for similar types of borrowing arrangements taking into account any optionality.

**Accrued Interest Receivable and Payable:** The carrying amounts of accrued interest receivable and payable approximate their fair values.

**Off-Balance Sheet Financial Instruments:** The Company's off-balance sheet instruments consist of loan commitments and standby letters of credit. Fair values for standby letters of credit were insignificant.

A summary of the carrying values and estimated fair values of the Company's significant financial instruments at June 30, 2016 and December 31, 2015, follows:

|                                    |                       |                       |                       |                       | <b>Total</b>      |
|------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-------------------|
| <b>June 30, 2016</b>               | <b>Carrying Value</b> | <b>Level 1 Inputs</b> | <b>Level 2 Inputs</b> | <b>Level 3 Inputs</b> | <b>Fair Value</b> |
| Financial Assets:                  |                       |                       |                       |                       |                   |
| Cash and cash equivalents          | \$ 25,867             | \$25,867              | \$ ---                | \$ ---                | \$ 25,867         |
| Federal Home Loan Bank stock       | 26,713                | ---                   | 26,713                | ---                   | 26,713            |
| Loans, net                         | 1,039,131             | ---                   | ---                   | 1,041,964             | 1,041,964         |
| Interest receivable                | 6,252                 | ---                   | 6,252                 | ---                   | 6,252             |
| Financial liabilities:             |                       |                       |                       |                       |                   |
| Deposits (with no stated maturity) | \$ 532,958            | \$ ---                | \$532,958             | \$ ---                | \$ 532,958        |
| Time deposits                      | 456,858               | ---                   | 461,990               | ---                   | 461,990           |
| Borrowings                         | 525,102               | ---                   | 526,690               | ---                   | 526,690           |
| Interest payable                   | 562                   | ---                   | 562                   | ---                   | 562               |

|                              |                       |                       |                       |                       | <b>Total</b>      |
|------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-------------------|
| <b>December 31, 2015</b>     | <b>Carrying Value</b> | <b>Level 1 Inputs</b> | <b>Level 2 Inputs</b> | <b>Level 3 Inputs</b> | <b>Fair Value</b> |
| Financial Assets:            |                       |                       |                       |                       |                   |
| Cash and cash equivalents    | \$ 9,720              | \$ 9,720              | \$ ---                | \$ ---                | \$ 9,720          |
| Federal Home Loan Bank stock | 21,479                | ---                   | 21,479                | ---                   | 21,479            |



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|                                    |            |        |           |         |            |
|------------------------------------|------------|--------|-----------|---------|------------|
| Loans, net                         | 980,631    | ---    | ---       | 975,610 | 975,610    |
| Interest receivable                | 5,420      | ---    | 5,420     | ---     | 5,420      |
| Financial liabilities:             |            |        |           |         |            |
| Deposits (with no stated maturity) | \$ 546,058 | \$ --- | \$546,058 | \$ ---  | \$ 546,058 |
| Time deposits                      | 396,729    | ---    | 399,146   | ---     | 399,146    |
| Borrowings                         | 474,791    | ---    | 473,404   | ---     | 473,404    |
| Interest payable                   | 527        | ---    | 527       | ---     | 527        |

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Management's discussion and analysis, which follows, focuses on the factors affecting the Company's consolidated results of operations for the three and six months ended June 30, 2016 and 2015, and financial condition at June 30, 2016 and December 31, 2015, and where appropriate, factors that may affect

future financial performance. The following discussion and analysis of financial condition and results of operations of the Company and its subsidiaries should be read in conjunction with the consolidated financial statements and notes thereto, and selected financial and statistical information appearing elsewhere in this report on Form 10-Q.

Amounts in the prior period financial statements are reclassified whenever necessary to conform to current period presentation.

Unless otherwise noted, all dollars are expressed in thousands except share data.

***Use of Non-GAAP Financial Measures:*** Certain information discussed below is presented on a fully taxable equivalent basis. Specifically, included in interest income for the second quarter of 2016 and 2015 was \$1,037 and \$894, respectively, of tax-exempt interest income from certain investment securities and loans. For the six months ended June 30, 2016 and 2015, the amount of tax exempt income included in interest income was \$2,094 and \$1,792, respectively.

An amount equal to the tax benefit derived from this tax exempt income has been added back to the interest income totals discussed in certain sections of this Management's Discussion and Analysis, representing tax equivalent adjustments of \$526 and \$451 in the second quarter of 2016 and 2015, respectively, which increased net interest income accordingly. The analysis of net interest income tables included in this report on Form 10-Q provide a reconciliation of tax equivalent financial information to the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles.

Management believes the disclosure of tax equivalent net interest income information improves the clarity of financial analysis, and is particularly useful to investors in understanding and evaluating the changes and trends in the Company's results of operations. Other financial institutions commonly present net interest income on a tax equivalent basis. This adjustment is considered helpful in the comparison of one financial institution's net interest income to that of another institution, as each will have a different proportion of tax-exempt interest from their earning asset portfolios. Moreover, net interest income is a component of a second financial measure commonly used by financial institutions, net interest margin, which is the ratio of net interest income to average earning assets. For purposes of this measure as well, other financial institutions generally use tax equivalent net interest income to provide a better basis of comparison from institution to institution. The Company follows these practices.

The Company presents its efficiency ratio using non-GAAP information. The GAAP efficiency ratio is computed by dividing non-interest expense by the sum of tax-equivalent net interest income and non-interest income. The non-GAAP efficiency ratio is computed by dividing non-interest expense by the sum of tax-equivalent net interest income and non-interest income other than net securities gains, and other significant non-recurring expenses.

**FORWARD LOOKING STATEMENTS DISCLAIMER**

Certain statements, as well as certain other discussions contained in this quarterly report on Form 10-Q, or incorporated herein by reference, contain statements which may be considered to be forward-looking within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Readers can identify these forward-looking statements by the use of words like "strategy," "expects," "plans," "believes," "will," "estimates," "intends," "projects," "goals," "targets," and other words of similar meaning. Readers can also identify them by the fact that they do not relate strictly to historical or current facts.

Investors are cautioned that forward-looking statements are inherently uncertain. Forward-looking statements include, but are not limited to, those made in connection with estimates with respect to the future results of operation, financial condition, and the business of the Company which are subject to

change based on the impact of various factors that could cause actual results to differ materially from those projected or suggested due to certain risks and uncertainties. Those factors include but are not limited to:

- (i) The Company's success is dependent to a significant extent upon general economic conditions in Maine, and Maine's ability to attract new business, as well as factors that affect tourism, a major source of economic activity in the Company's immediate market areas;
- (ii) The Company's earnings depend to a great extent on the level of net interest income (the difference between interest income earned on loans and investments and the interest expense paid on deposits and borrowings) generated by the Company's wholly-owned banking subsidiary, Bar Harbor Bank & Trust (the Bank), and thus the Company's results of operations may be adversely affected by increases or decreases in interest rates;
- (iii) The banking business is highly competitive and the profitability of the Company depends on the Bank's ability to attract loans and deposits in Maine, where the Bank competes with a variety of traditional banking and non-traditional institutions, such as credit unions and finance companies;
- (iv) A significant portion of the Bank's loan portfolio is comprised of commercial loans and loans secured by real estate, exposing the Company to the risks inherent in financings based upon analysis of credit risk, the value of underlying collateral, and other intangible factors which are considered in making commercial loans and, accordingly, the Company's profitability may be negatively impacted by judgment errors in risk analysis, by loan defaults, and the ability of certain borrowers to repay such loans during a downturn in general economic conditions;
- (v) Adverse changes in repayment performance and fair value of underlying residential mortgage loan collateral, that differ from the Company's current estimates, could change the Company's expectations that it will recover the amortized cost of its private label mortgage backed securities portfolio and/or its conclusion that such securities were not other-than temporarily impaired as of the date of this report;
- (vi) Significant changes in the Company's internal controls, or internal control failures;
- (vii) Acts or threats of terrorism and actions taken by the United States or other governments as a result of such threats, including military action, could further adversely affect business and economic conditions in the United States generally and in the Company's markets, which could have an adverse effect on the Company's financial performance and that of borrowers and on the financial markets and the price of the Company's common stock;
- (viii) Significant changes in the extensive laws, regulations, and policies governing bank holding companies and their subsidiaries could alter the Company's business environment or affect its operations;
- (ix) Changes in general, national, international, regional or local economic conditions and credit markets which are less favorable than those anticipated by Company management that could impact the Company's securities portfolio, quality of credits, or the overall demand for the Company's products or services;
- (x)

The integrity of information systems are under significant threat from cyber attacks by third-parties, including thorough coordinated attacks sponsored by foreign nations and criminal organizations to disrupt business operations and other compromises to data and systems for political or criminal purposes;

- (xi) The factors that could also cause actual results to differ materially from current expectations include failure to complete the proposed LSBG Merger, the imposition of adverse regulatory conditions in connection with regulatory approval of the proposed LSBG Merger, disruption to the parties' businesses as a result of the announcement and pendency of the LSBG Merger, the inability to realize expected cost savings or to implement integration plans and other adverse consequences associated with the LSBG Merger, and
- (xii) The factors that could also cause actual results to differ materially from current expectations include failure to complete the proposed LSBG Merger, the imposition of adverse regulatory conditions in connection with regulatory approval of the proposed LSBG Merger, disruption to the parties' businesses as a result of the announcement and pendency of the LSBG Merger, the inability to realize expected cost savings or to implement integration plans and other adverse consequences associated with the LSBG Merger, and
- (xiii) The Company's success in managing the risks involved in all of the foregoing matters.

Readers should carefully review all of these factors as well as the risk factors set forth in Item 1A- Risk Factors, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2015, and as updated in Part II, Item 1A of this report. There may be other risk factors that could cause differences in future periods from those anticipated by management.

The forward-looking statements contained herein represent the Company's judgment as of the date of this quarterly report on Form 10-Q and the Company cautions readers not to place undue reliance on such statements. The Company disclaims any obligation to publicly update or revise any forward-looking statement contained in the succeeding discussion, or elsewhere in this quarterly report on Form 10-Q, except to the extent required by federal securities laws.

## **APPLICATION OF CRITICAL ACCOUNTING POLICIES**

The Company's significant accounting policies are more fully enumerated in Note 1 to the Consolidated Financial Statements included in Item 8 of its December 31, 2015, report on Form 10-K. The reader of the financial statements should review these policies to gain a greater understanding of how the Company's financial performance is reported.

Management's discussion and analysis of the Company's financial condition and results of operations are based on the Consolidated Financial Statements, which are prepared in accordance with U.S. generally accepted accounting principles. The preparation of such financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and

liabilities. Management evaluates its estimates on an ongoing basis. Management bases its estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis in making judgments about the carrying values of assets that are not readily apparent from other sources. Actual results could differ from the amount derived from management's estimates and assumptions under different assumptions or conditions. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, other than temporary impairment on securities, income tax estimates, and the evaluation of intangible assets. The use of these estimates is more fully described in Part I, Item 1, Note 5 of the consolidated financial statements in this quarterly report on Form 10-Q.

## SUMMARY FINANCIAL RESULTS

For the three months ended June 30, 2016, the Company reported net income of \$4,311, compared with \$3,873 for the second quarter of 2015, representing an increase of \$438, or 11.3%. The Company's diluted earnings per share amounted to \$0.71 for the quarter representing an increase of \$0.07, or 10.9%, compared with the second quarter of 2015. The Company's annualized return on average shareholders' equity amounted to 10.72% for the quarter, compared with 10.31% for the second quarter of 2015. The Company's annualized return on average assets amounted to 1.05% for the quarter, compared with 1.01% for the second quarter of 2015.

On May 5, 2016, the Company announced the signing of a definitive agreement and plan of merger pursuant to which the Company will acquire Lake Sunapee Bank Group (LSBG) in an all-stock transaction valued at approximately \$143 million (the Merger). The market expanding Merger is expected to create efficiencies and strategic growth opportunities for both businesses through the leveraging of each other's platforms and capabilities, and will create the only community bank headquartered in New England with a market footprint in all three Northern New England states of Maine, New Hampshire and Vermont. At closing, the combined institution is expected to have approximately \$3.3 billion in assets, \$2.4 billion in loans, \$2.2 billion in deposits and over \$2.0 billion in assets under management. The Company will have a pro forma market cap of approximately \$350 million and 49 branches serving customers and communities across three states. The Merger is expected to be completed in the fourth quarter of 2016 or the first quarter of 2017. The consummation of the Merger is subject to receipt of the requisite approval of the Company's shareholders and LSBG shareholders, receipt of all required regulatory approvals, and other customary closing conditions. Included in the Company's second quarter non-interest expense was \$492 in non-recurring expenses related to the LSBG Merger, largely legal and other professional fees.

For the six months ended June 30, 2016, the Company reported net income of \$8,717, compared with \$7,754, representing an increase of \$963, or 12.4% when compared to the same period in 2015. The Company's diluted earnings per share amounted to \$1.43 for the six months ended June 30, 2016, representing an increase of \$0.15, or 11.7%, compared with the same period in 2015. The Company's annualized return on average shareholders' equity amounted to 10.95%, compared with 10.44% in the first half of 2015. The Company's annualized return on average assets amounted to 1.07%, compared with 1.04% for the six months ended June 30, 2015.

As more fully enumerated in the following management discussion and analysis, the Company's year-to-date operating results were highlighted by a \$993, or 4.4%, increase in tax-equivalent net interest income, despite a twelve basis

point decline in the tax-equivalent net interest margin compared with

the first half of 2015. Led by a \$1,929 increase in realized securities gains, total non-interest income increased \$2,097, or 43.3%, compared with the six months ended June 30, 2015.

Led by growth in the loan and securities portfolios, total assets ended the second quarter at \$1,687,549, representing an increase of \$107,494, or 6.8%, compared with December 31, 2015. Total loans ended the second quarter at \$1,049,022, representing an increase of \$58,952, or 6.0%, compared with December 31, 2015. The credit quality of the loan portfolio remained stable during the first half of 2016, highlighted by a \$1,455, or 20.8%, decline in non-performing loans compared with December 31, 2015. Net loan charge-offs amounted to \$163 the six months ended June 30, 2016, or annualized net charge-offs to average loans outstanding of 0.03%.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income is the principal component of the Company's income stream and represents the difference or spread between interest generated from earning assets and the interest expense paid on deposits and borrowed funds. Net interest income is entirely generated by the Bank. Fluctuations in market interest rates as well as volume and mix changes in earning assets and interest bearing liabilities can materially impact net interest income.

**Total Net Interest Income:** For the three months ended June 30, 2016, net interest income on a tax-equivalent basis amounted to \$11,908, compared with \$11,337 for the second quarter of 2015, representing an increase of \$571, or 5.0%. The increase in second quarter 2016 tax-equivalent net interest income compared with the second quarter of 2015 was attributed to average earning asset growth of \$116,530, or 8.0%, as the tax-equivalent net interest margin declined eight basis points to 3.04%.

For the six months ended June 30, 2016, net interest income on a tax-equivalent basis amounted to \$23,781, compared with \$22,788 for the first half of 2015, representing an increase of \$993, or 4.4%. The increase in tax-equivalent net interest income compared with the first half of 2015 was attributed to average earning asset growth of \$120,146, or 8.3%, as the tax-equivalent net interest margin declined twelve basis points to 3.07%.



Factors contributing to the changes in net interest income and the net interest margin are more fully enumerated in the following discussion and analysis.

***Net Interest Income Analysis:*** The following tables summarize the Company's average balance sheet and components of net interest income, including a reconciliation of tax-equivalent adjustments, for the three and six months ended June 30, 2016, and 2015:



**AVERAGE BALANCE SHEET AND****ANALYSIS OF NET INTEREST INCOME****THREE MONTHS ENDED****JUNE 30, 2016 AND 2015**

|   | 2016               |          |                             | 2015               |          |                             |
|---|--------------------|----------|-----------------------------|--------------------|----------|-----------------------------|
|   | Average<br>Balance | Interest | Weighted<br>Average<br>Rate | Average<br>Balance | Interest | Weighted<br>Average<br>Rate |
| <b>Interest Earning Assets:</b>                 |                    |          |                             |                    |          |                             |
| Loans (1,3)                                     | \$1,028,748        | \$10,308 | <b>4.03%</b>                | \$ 953,800         | \$ 9,707 | <b>4.08%</b>                |
| Securities (2,3)                                | 521,373            | 4,367    | <b>3.37%</b>                | 481,947            | 4,121    | <b>3.43%</b>                |
| Federal Home Loan Bank stock                    | 25,544             | 205      | <b>3.23%</b>                | 23,388             | 95       | <b>1.63%</b>                |
| Total Earning Assets                            | 1,575,665          | 14,880   | <b>3.80%</b>                | 1,459,135          | 13,923   | <b>3.83%</b>                |
| <b>Non-Interest Earning Assets:</b>             |                    |          |                             |                    |          |                             |
| Cash and due from banks                         | 5,400              |          |                             | 4,313              |          |                             |
| Allowance for loan losses                       | (10,036)           |          |                             | (9,416)            |          |                             |
| Other assets (2)                                | 80,547             |          |                             | 79,009             |          |                             |
| Total Assets                                    | \$1,651,576        |          |                             | \$1,533,041        |          |                             |
| <b>Interest Bearing Liabilities:</b>            |                    |          |                             |                    |          |                             |
| Deposits  | \$ 845,042         | \$ 1,599 | <b>0.76%</b>                | \$ 803,474         | \$ 1,460 | <b>0.73%</b>                |
| Borrowings                                      | 557,593            | 1,373    | <b>0.99%</b>                | 499,293            | 1,126    | <b>0.90%</b>                |
| Total Interest Bearing Liabilities              | 1,402,635          | 2,972    | <b>0.85%</b>                | 1,302,767          | 2,586    | <b>0.80%</b>                |
| Rate Spread                                     |                    |          | <b>2.95%</b>                |                    |          | <b>3.03%</b>                |
| <b>Non-Interest Bearing Liabilities:</b>        |                    |          |                             |                    |          |                             |
| Demand and other non-interest bearing deposits  | 80,119             |          |                             | 73,013             |          |                             |
| Other liabilities                               | 7,147              |          |                             | 6,607              |          |                             |
| Total Liabilities                               | 1,489,901          |          |                             | 1,382,387          |          |                             |
| Shareholders' equity                            | 161,675            |          |                             | 150,654            |          |                             |
| Total Liabilities and Shareholders' Equity      | \$1,651,576        |          |                             | \$1,533,041        |          |                             |
| Net interest income and net interest margin (3) |                    | 11,908   | <b>3.04%</b>                |                    | 11,337   | <b>3.12%</b>                |
| Less: Tax Equivalent adjustment                 |                    | (526)    |                             |                    | (451)    |                             |
| Net Interest Income                             |                    | \$11,382 | <b>2.91%</b>                |                    | \$10,886 | <b>2.99%</b>                |

(1) For purposes of these computations, non-accrual loans are included in average loans.

*(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.*

*(3) For purposes of these computations, net interest income and net interest margin are reported on a tax-equivalent basis.*

**AVERAGE BALANCE SHEET AND  
ANALYSIS OF NET INTEREST INCOME  
SIX MONTHS ENDED  
JUNE 30, 2016 AND 2015**

|   | <b>2016</b>                |                 |                                      | <b>2015</b>                |                 |                                      |
|---|----------------------------|-----------------|--------------------------------------|----------------------------|-----------------|--------------------------------------|
|   | <b>Average<br/>Balance</b> | <b>Interest</b> | <b>Weighted<br/>Average<br/>Rate</b> | <b>Average<br/>Balance</b> | <b>Interest</b> | <b>Weighted<br/>Average<br/>Rate</b> |
| <b>Interest Earning Assets:</b>                 |                            |                 |                                      |                            |                 |                                      |
| Loans (1,3)                                     | \$1,020,341                | \$20,450        | <b>4.03%</b>                         | \$ 943,810                 | \$19,446        | <b>4.15%</b>                         |
| Securities (2,3)                                | 515,342                    | 8,750           | <b>3.41%</b>                         | 473,232                    | 8,274           | <b>3.53%</b>                         |
| Federal Home Loan Bank stock                    | 24,159                     | 381             | <b>3.17%</b>                         | 22,654                     | 189             | <b>1.68%</b>                         |
| Total Earning Assets                            | 1,559,842                  | 29,581          | <b>3.81%</b>                         | 1,439,696                  | 27,909          | <b>3.91%</b>                         |
| <b>Non-Interest Earning Assets:</b>             |                            |                 |                                      |                            |                 |                                      |
| Cash and due from banks                         | 5,069                      |                 |                                      | 4,076                      |                 |                                      |
| Allowance for loan losses                       | (9,905)                    |                 |                                      | (9,293)                    |                 |                                      |
| Other assets (2)                                | 79,547                     |                 |                                      | 75,572                     |                 |                                      |
| Total Assets                                    | \$1,634,553                |                 |                                      | \$1,510,051                |                 |                                      |
| <b>Interest Bearing Liabilities:</b>            |                            |                 |                                      |                            |                 |                                      |
| Deposits  | \$ 863,021                 | \$ 3,176        | <b>0.74%</b>                         | \$ 792,212                 | \$ 2,913        | <b>0.74%</b>                         |
| Borrowings                                      | 523,293                    | 2,624           | <b>1.01%</b>                         | 486,859                    | 2,208           | <b>0.91%</b>                         |
| Total Interest Bearing Liabilities              | 1,386,314                  | 5,800           | <b>0.84%</b>                         | 1,279,071                  | 5,121           | <b>0.81%</b>                         |
| Rate Spread                                     |                            |                 | <b>2.97%</b>                         |                            |                 | <b>3.10%</b>                         |
| <b>Non-Interest Bearing Liabilities:</b>        |                            |                 |                                      |                            |                 |                                      |
| Demand and other non-interest bearing deposits  | 81,697                     |                 |                                      | 74,256                     |                 |                                      |
| Other liabilities                               | 6,444                      |                 |                                      | 6,908                      |                 |                                      |
| Total Liabilities                               | 1,474,455                  |                 |                                      | 1,360,235                  |                 |                                      |
| Shareholders' equity                            | 160,098                    |                 |                                      | 149,816                    |                 |                                      |
| Total Liabilities and Shareholders' Equity      | \$1,634,553                |                 |                                      | \$1,510,051                |                 |                                      |
| Net interest income and net interest margin (3) |                            | 23,781          | <b>3.07%</b>                         |                            | 22,788          | <b>3.19%</b>                         |

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|                                 |          |       |          |       |
|---------------------------------|----------|-------|----------|-------|
| Less: Tax Equivalent adjustment | (1,063)  |       | (904)    |       |
| Net Interest Income             | \$22,718 | 2.93% | \$21,884 | 3.07% |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.

(3) For purposes of these computations, net interest income and net interest margin are reported on a tax-equivalent basis.

**Net Interest Margin:** The net interest margin, expressed on a tax equivalent basis, represents the difference between interest and dividends earned on interest-earning assets and interest paid to depositors and other creditors, expressed as a percentage of average earning assets.

The net interest margin is determined by dividing tax equivalent net interest income by average interest-earning assets. The interest rate spread represents the difference between the average tax equivalent yield earned on interest earning-assets and the average rate paid on interest bearing liabilities. The net interest margin is generally higher than the interest rate spread due to the additional income earned on those assets funded by non-interest bearing liabilities, primarily demand deposits and shareholders' equity.

For the three months ended June 30, 2016, the tax equivalent net interest margin amounted to 3.04%, compared with 3.12% in the second quarter of 2015, representing a decline of eight basis points. The decline in the net interest margin was attributed to a three basis point decline in the weighted average yield on earning assets, combined with a five basis point increase in the weighted average cost of interest bearing liabilities, compared with the second quarter of 2015.

For the six months ended June 30, 2016, the tax equivalent net interest margin amounted to 3.07%, compared with 3.19% in the first half of 2015, representing a decline of twelve basis points. The decline in the net interest margin was attributed to a ten basis point decline in the weighted average yield on earning assets, combined with a three basis point increase in the weighted average cost of interest bearing liabilities, compared with the six months ended June 30, 2015.



The following table summarizes the net interest margin components, on a quarterly basis, over the past two years. Factors contributing to the changes in the net interest margin are further enumerated in the following discussion and analysis.

## NET INTEREST MARGIN ANALYSIS

### FOR QUARTER ENDED

#### WEIGHTED AVERAGE RATES

| Quarter:  | 2016  |       | 2015  |       |       |       | 2014  |       |
|---|-------|-------|-------|-------|-------|-------|-------|-------|
|   | 2     | 1     | 4     | 3     | 2     | 1     | 4     | 3     |
| <b>Interest Earning Assets:</b>   |       |       |       |       |       |       |       |       |
| Loans (1,3)   | 4.03% | 4.03% | 4.05% | 4.08% | 4.08% | 4.23% | 4.19% | 4.44% |
| Securities (2,3)  | 3.37% | 3.46% | 3.47% | 3.56% | 3.43% | 3.63% | 3.74% | 3.50% |
| Federal Home Loan Bank stock  | 3.23% | 3.11% | 3.85% | 3.21% | 1.63% | 1.74% | 1.50% | 1.32% |
| Fed Funds sold, money market funds,<br>and time deposits with other banks | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Total Earning Assets  | 3.80% | 3.83% | 3.86% | 3.89% | 3.83% | 3.99% | 4.00% | 4.08% |
| <b>Interest Bearing Liabilities:</b>                                      |       |       |       |       |       |       |       |       |
| Deposits  | 0.76% | 0.72% | 0.71% | 0.70% | 0.73% | 0.75% | 0.75% | 0.73% |
| Borrowings  | 0.99% | 1.03% | 1.01% | 0.93% | 0.90% | 0.93% | 0.96% | 0.89% |
| Total Interest Bearing Liabilities  | 0.85% | 0.83% | 0.80% | 0.78% | 0.80% | 0.82% | 0.82% | 0.79% |
| Rate Spread   | 2.95% | 3.00% | 3.06% | 3.11% | 3.03% | 3.17% | 3.18% | 3.29% |
| Net Interest Margin (3)   | 3.04% | 3.09% | 3.15% | 3.20% | 3.12% | 3.27% | 3.28% | 3.38% |
| Net Interest Margin without   |       |       |       |       |       |       |       |       |
| Tax Equivalent Adjustments  | 2.91% | 2.95% | 3.01% | 3.07% | 2.99% | 3.14% | 3.15% | 3.25% |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.

(3) For purposes of these computations, net interest income and net interest margin are reported on a tax-equivalent basis.



***Interest and Dividend Income:*** For the three months ended June 30, 2016, total interest and dividend income on a tax-equivalent basis amounted to \$14,880, compared with \$13,923 in the second quarter of 2015, representing an increase of \$957, or 6.9%. The increase in interest and dividend income was principally attributed to average earning asset growth of \$116,530, or 8.0%, as the weighted average earning asset yield declined three basis points to 3.80%.

For the three months ended June 30, 2016, total tax-equivalent interest income from the securities portfolio amounted to \$4,367, compared with \$4,121 in the second quarter of 2015, representing an increase of \$246, or 6.0%. The increase in interest income from securities was principally attributed to a \$39,426, or 8.2%, increase in total average securities, which was partially offset by a six basis point decline in the weighted average securities yield to 3.37%. The decline in the weighted average securities yield was principally attributed to the ongoing replacement of MBS cash flows as well as incremental securities growth in a historically low interest rate environment.

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For the three months ended June 30, 2016, total tax-equivalent interest income from the loan portfolio amounted to \$10,308, compared with \$9,707 in the second quarter of 2015, representing an increase of \$601, or 6.2%. The increase in interest income from loans was principally attributed to a \$74,948, or 7.9% increase in the average loan portfolio, which was partially offset by a five basis point decline in the weighted average loan yield to 4.03%. The decline in the weighted average loan yield principally reflected the origination and competitive re-pricing of certain commercial loans, as well as residential mortgage loan origination and refinancing activity, during a period of still-historically low interest rates. Partially offsetting the foregoing considerations was the increase in the Fed Funds rate in December 2015, which favorably impacted the yield on the Bank's variable rate loan portfolios.

For the six months ended June 30, 2016, total interest and dividend income on a tax-equivalent basis amounted to \$29,581, compared with \$27,907 in the first half of 2015, representing an increase of \$1,674, or 6.0%. The increase in interest and dividend income was principally attributed to average earning asset growth of \$120,146, or 8.3%, as the weighted average earning asset yield declined ten basis points to 3.81%.

For the six months ended June 30, 2016, total tax-equivalent interest income from the securities portfolio amounted to \$8,750, compared with \$8,274 in the first half of 2015, representing an increase of \$476, or 5.8%. The increase in interest income from securities was principally attributed to a \$42,110, or 8.9%, increase in total average securities, which was partially offset by a twelve basis point decline in the weighted average securities yield to 3.41%. The decline in the weighted average securities yield was principally attributed to the ongoing replacement of MBS cash flows as well as incremental securities growth in a historically low interest rate environment.

For the six months ended June 30, 2016, total tax-equivalent interest income from the loan portfolio amounted to \$20,450, compared with \$19,446 in the first half of 2015, representing an increase of \$1,004, or 5.2%. The increase in interest income from loans was principally attributed to a \$76,531, or 8.1% increase in the average loan portfolio, which was partially offset by a twelve basis point decline in the weighted average loan yield to 4.03%. The decline in the weighted average loan yield principally reflected the origination and competitive re-pricing of certain commercial loans, as well as residential mortgage loan origination and refinancing activity, during a period of still-historically low interest rates. Partially offsetting the foregoing considerations was the increase in the Fed Funds rate in December 2015, which favorably impacted the yield on the Bank's variable rate loan portfolios.

**Interest Expense:** For the three months ended June 30, 2016, total interest expense amounted to \$2,972, compared with \$2,586 in the second quarter of 2015, representing an increase of \$386, or 14.9%. The increase in interest expense was principally attributed to a \$99,868 or 7.7% increase in total average interest bearing liabilities and, to a lesser extent, a five basis point increase in the weighted average cost of interest bearing liabilities to 0.85%, compared with the second quarter of 2015.

The increase in the weighted average cost of interest bearing liabilities compared with the second quarter of 2015 was principally attributed to a higher weighted average rate on borrowings, largely reflecting the December 2015 Fed Funds increase by the Federal Reserve. For the three months ended June 30, 2016, the total weighted average cost of interest bearing liabilities amounted to 0.85%, compared with 0.80% in the second quarter of 2015. The weighted average cost of borrowed funds increased nine basis points to 0.99%, while the weighted average cost of interest

bearing deposits increased three basis points to 0.76%, compared with the second quarter of 2015.

For the six months ended June 30, 2016, total interest expense amounted to \$5,800, compared with \$5,121 in the first half of 2015, representing an increase of \$679, or 13.3%. The increase in interest expense was principally attributed to a \$107,243, or 8.4% increase in total average interest bearing liabilities and, to a lesser extent, a three basis point increase in the weighted average cost of interest bearing liabilities to 0.84%, compared with the first half of 2015.

The increase in the weighted average cost of interest bearing liabilities compared with the first half of 2015 was principally attributed to a higher weighted average rate on borrowings, largely reflecting the December 2015 Fed Funds increase by the Federal Reserve. For the six months ended June 30, 2016, the total weighted average cost of interest bearing liabilities amounted to 0.84%, compared with 0.81% in the first half of 2015. The weighted average cost of borrowed funds increased ten basis points to 1.01%, while the weighted average cost of interest bearing deposits remained unchanged at 0.74%, compared with the first half of 2015.

**Rate/Volume Analysis:** The following tables set forth a summary analysis of the relative impact on net interest income of changes in the average volume of interest earning assets and interest bearing liabilities, and changes in average rates on such assets and liabilities. The income from tax-exempt assets has been adjusted to a fully tax equivalent basis, thereby allowing uniform comparisons to be made. Because of the numerous simultaneous volume and rate changes during the periods analyzed, it is not possible to precisely allocate changes to volume or rate. For presentation purposes, changes which are not solely due to volume changes or rate changes have been allocated to these categories in proportion to the relationships of the absolute dollar amounts of the change in each.

## ANALYSIS OF VOLUME AND RATE CHANGES ON NET INTEREST INCOME

### THREE MONTHS ENDED JUNE 30, 2016 and 2015

#### INCREASES (DECREASES) DUE TO:

|   | Average<br>Volume | Average<br>Rate | Total<br>Change |
|---|-------------------|-----------------|-----------------|
| Loans (1,3)                               | \$ 763            | \$(162)         | \$601           |
| Securities (2,3)                          | 337               | (91)            | 246             |
| Federal Home Loan Bank stock              | 9                 | 101             | 110             |
| <b>TOTAL EARNING ASSETS</b>               | <b>\$1,109</b>    | <b>\$(152)</b>  | <b>\$957</b>    |
| Interest bearing deposits                 | 76                | 63              | 139             |
| Borrowings                                | 132               | 115             | 247             |
| <b>TOTAL INTEREST BEARING LIABILITIES</b> | <b>\$ 208</b>     | <b>\$ 178</b>   | <b>\$386</b>    |
| <b>NET CHANGE IN NET INTEREST INCOME</b>  | <b>\$ 901</b>     | <b>\$(330)</b>  | <b>\$571</b>    |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.

(3) For purposes of these computations, interest income is reported on a tax-equivalent basis.

## ANALYSIS OF VOLUME AND RATE CHANGES ON NET INTEREST INCOME

SIX MONTHS ENDED JUNE 30, 2016 and 2015

### INCREASES (DECREASES) DUE TO:

|                                    | Average<br>Volume | Average<br>Rate | Total<br>Change |
|------------------------------------|-------------------|-----------------|-----------------|
| Loans (1,3)                        | \$1,576           | \$(572)         | \$1,004         |
| Securities (2,3)                   | 736               | (260)           | 476             |
| Federal Home Loan Bank stock       | 13                | 179             | 192             |
| TOTAL EARNING ASSETS               | \$2,325           | \$(653)         | \$1,672         |
| Interest bearing deposits          | 261               | 2               | 263             |
| Borrowings                         | 165               | 251             | 416             |
| TOTAL INTEREST BEARING LIABILITIES | \$ 426            | \$ 253          | \$ 679          |
| NET CHANGE IN NET INTEREST INCOME  | \$1,899           | \$(906)         | \$ 993          |

(1) For purposes of these computations, non-accrual loans are included in average loans.

(2) For purposes of these computations, unrealized gains (losses) on available-for-sale securities are recorded in other assets.

(3) For purposes of these computations, interest income is reported on a tax-equivalent basis.

### Provision for Loan Losses

The provision for loan losses (the provision ) reflects the amount necessary to maintain the allowance for loan losses at a level that, in management's judgment, is appropriate for the amount of inherent risk of probable loss in the Bank's current loan portfolio.

The overall credit quality of the Bank's loan portfolio remained stable during the six months ended June 30, 2016, highlighted by a \$1,445, or 20.8%, decline in non-performing loans. Total non-performing loans expressed as a percentage of total loans ended the quarter at 0.53%, down from 0.71% at December 31, 2015. Similarly, the allowance for loan losses expressed as a ratio to non-performing loans ended the quarter at 178.1%, up from 134.7% at December 31, 2015. For the six months ended June 30, 2016, total net loan charge-offs amounted to \$163, or annualized net charge-offs to average loans outstanding of 0.03%, compared with \$765 and 0.16%, respectively, compared with the six months ended June 30, 2015.

For the three and six months ended June 30, 2016, the Bank recorded provisions of \$150 and \$615, compared with \$400 and \$895 for the same periods in 2015, representing declines of \$250 and \$280, or 62.5% and 31.3%, respectively.

Refer below to Item 2 of this Part I, Financial Condition, Loans, *Non-Performing Loans, Potential Problem Loans and Allowance for Loan Losses*, in this report on Form 10-Q for further discussion and analysis related to the provision for loan losses.

### **Non-interest Income**

For the three and six months ended June 30, 2016, total non-interest income amounted to \$3,614 and \$6,942, compared with \$2,503 and \$4,845 for the same periods in 2015, representing increases of \$1,111 and \$2,097, or 44.4% and 43.3%, respectively.

Factors contributing to the changes in non-interest income are enumerated in the following discussion and analysis.

***Trust and Other Financial Services:*** Income from trust and other financial services is principally derived from fee income based on a percentage of the fair market value of client assets under management and held in custody with Bar Harbor Trust Services, the Company's second tier non-depository trust company subsidiary, and, to a lesser extent, revenue from brokerage services conducted through Bar Harbor Financial Services, an independent third-party broker.

For the three and six months ended June 30, 2016, trust and other financial service fees amounted to \$955 and \$1,903, compared with \$985 and \$1,930 for the same periods in 2015, representing declines of \$30 and \$27, or 3.0% and 1.4%, respectively. The foregoing declines largely reflected lower levels of retail brokerage activity as well as broad declines and volatility in the equity markets.

***Service Charges on Deposit Accounts:*** Service charges on deposits are principally derived from customer overdraft fees. For the three months ended June 30, 2016, income from service charges on deposit accounts amounted to \$252, compared with \$255 in the second quarter of 2015, representing a decline of \$3, or 1.2%. For the six months ended June 30, 2016, service charges on deposits amounted to \$463, compared with \$453 in the first half of 2015, representing an increase of \$10, or 2.2%. The Bank has not been aggressive in selling its fee based overdraft products as a cautionary measure in light of continued regulatory pressure on the banking industry including the Consumer Financial Protection Bureau, which was established by the Wall Street Reform and Consumer Protection Act (the Dodd Frank Act ).

**Debit Card Service Charges and Fees:** For the three and six months ended June 30, 2016, income generated from debit card service charges and fees amounted to \$430 and \$830, compared with \$402 and \$768 for the same periods in 2015, representing increases of \$28 and \$62, or 7.0% and 8.1%, respectively. These increases were attributed to continued growth of the Bank's retail deposit base and continued success with a program that offers rewards for certain debit card transactions.

**Net Securities Gains:** For the three and six months ended June 30, 2016, the Bank recorded realized securities gains of \$1,699 and \$3,135, compared with \$587 and \$1,206 for the same periods in 2015, representing increases of \$1,112 and \$1,929, or 189.4% and 160.0%, respectively. During the first half of 2016 long term interest rates declined to near record lows providing a meaningful opportunity to realize attractive securities gains while continuing a strategy of lowering the duration of the securities portfolio and the Bank's overall interest rate risk profile.

**Other Operating Income:** Other operating income principally includes income from bank-owned life insurance, representing increases in the cash surrender value of life insurance policies on the lives of certain current and retired employees who had provided positive consent allowing the Bank to be the beneficiary of such policies. Other operating income also includes a variety of miscellaneous service charges and fees including fees for non-customer ATM transactions.

For the three and six months ended June 30, 2016, total other operating income amounted to \$278 and \$611, compared with \$274 and \$488 for the same periods in 2015, representing increases of \$4 and \$123, or 1.5% and 25.2%, respectively. The increase in other operating income was almost entirely attributed to the Bank's purchase of additional Bank Owned Life Insurance ( BOLI ) late in the first quarter of 2015. Further information regarding BOLI is incorporated by reference to the below *Financial Condition* management discussion and analysis covering *Bank Owned Life Insurance* in this report on Form 10-Q.

### **Non-interest Expense**

For the three and six months ended June 30, 2016, total non-interest expense amounted to \$8,731 and \$16,728, compared with \$7,601 and \$14,934 for the same periods in 2015, representing increases of \$1,130 and \$1,794, or 14.9% and 12.0%, respectively.

Factors contributing to the changes in non-interest expense are more fully enumerated in the following discussion and analysis.

**Salaries and Employee Benefits:** For the three and six months ended June 30, 2016, total salaries and employee benefits expense amounted to \$4,799 and \$9,816, compared with \$4,269 and \$8,621 for the same periods in 2015, representing increases of \$530 and \$1,195, or 12.4% and 13.9%, respectively. The increases in salaries and employee

benefits were attributed to a variety of factors including normal increases in base salaries and higher levels of employee health insurance, higher levels of employee incentive and equity compensation, as well as increases in staffing levels and strategic changes in staffing mix. Additionally, over the past year the Company strengthened its risk management and information technology staff resources in anticipation of future growth.

***Debit Card Expenses:*** These expenses relate to the Bank's Visa debit card processing activities. For the three and six months ended June 30, 2016, total debit card expense amounted to \$120 and \$237, compared with \$112 and \$208 for the same periods in 2015, representing increases of \$8 and \$29, or 7.1% and 13.9%, respectively. These increases were principally attributed to higher transaction volumes and were more than offset with higher revenues from debit card activity.



**Other Operating Expenses:** For the three and six months ended June 30, 2016, total other operating expenses amounted to \$2,442 and \$3,930, compared with \$1,863 and \$3,402 for the same periods in 2015, representing increases of \$579 and \$528, or 31.1% and 15.5%, respectively. Included in second quarter and year-to-date other operating expense was \$492 in non-recurring expenses related to the LSBG acquisition, largely legal and other professional fees.

### **Efficiency Ratio**

The Company's efficiency ratio measures the relationship of operating expenses to revenues. The efficiency ratio is calculated by dividing non-interest operating expenses divided by the sum of tax-equivalent income other than net securities gains, and other significant non-recurring expenses. For the three and six months ended June 30, 2016, the Company's efficiency ratios amounted to 58.8% and 58.0%, compared with 56.5% and 55.8% for the same periods in 2015, respectively.

## **FINANCIAL CONDITION**

### **Total Assets**

The Company's assets principally consist of loans and securities, which at June 30, 2016 represented 62.2% and 31.6%, respectively, of total assets, compared with 62.7% and 32.0%, respectively, at December 31, 2015.

At June 30, 2016, the Company's total assets stood at \$1,687,549, compared with \$1,580,055 at December 31, 2015, representing an increase of \$107,494, or 6.8%.

### **Securities**

The securities portfolio is comprised of mortgage-backed securities ( MBS ) issued by U.S. Government agencies, U.S. Government sponsored enterprises and, to a much lesser extent, other non-agency, private label issuers. The portfolio also includes tax-exempt obligations of state and political subdivisions.

Management considers securities as a relatively attractive means to effectively leverage the Bank's strong capital position, as securities are typically assigned significantly lower risk weightings compared with the Bank's other earning assets for the purpose of calculating the Bank's and the Company's risk-based capital ratios. The overall objectives of the Company's strategy for the securities portfolio include maintaining appropriate liquidity reserves, diversifying earning assets, managing interest rate risk, leveraging the Company's strong capital position, and generating acceptable levels of net interest income.

Securities available for sale represented 100% of total securities at June 30, 2016, and December 31, 2015. Securities available for sale are reported at their fair value with unrealized gains or losses, net of taxes, excluded from earnings but shown separately as a component of shareholders' equity. As of June 30, 2016, total net unrealized securities gains amounted to \$17,408, compared with net unrealized gains of \$8,790 at December 31, 2015. The increase in unrealized gains was attributed to market interest rates, which declined to near record lows at the end of the current quarter.

**Total Securities:** At June 30, 2016, total securities amounted to \$532,590, compared with \$504,969 at December 31, 2015, representing an increase of \$27,621, or 5.5%. The securities purchased during the first quarter consisted of MBS issued and guaranteed by U.S. Government agencies and sponsored-enterprises, as well as obligations of states and political subdivisions thereof (municipal securities).

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The following tables summarize the securities available for sale portfolio as of June 30, 2016 and December 31, 2015:

| <b>June 30, 2016</b>                | <b>Gross</b>                                     |              | <b>Gross</b>  |                   |
|-------------------------------------|--|--------------|---------------|-------------------|
|                                     | <b>Amortized Unrealized Unrealized Estimated</b> |              |               |                   |
| <b>Available for Sale:</b>          | <b>Cost</b>                                      | <b>Gains</b> | <b>Losses</b> | <b>Fair Value</b> |
| Mortgage-backed securities:         |  |              |               |                   |
| US Government-sponsored enterprises | \$323,684  | \$ 9,693     | \$ 397        | \$332,980         |
| US Government agency                | 80,472   | 1,993        | 97            | 82,368            |
| Private label                       | 1,128  | 218          | 19            | 1,327             |
| Obligations of states and           |  |              |               |                   |
| political subdivisions thereof      | 109,898  | 6,108        | 91            | 115,915           |
| Total                               | \$515,182  | \$18,012     | \$ 604        | \$532,590         |

| <b>December 31, 2015</b>            | <b>Gross</b>                                     |              | <b>Gross</b>  |                   |
|-------------------------------------|--|--------------|---------------|-------------------|
|                                     | <b>Amortized Unrealized Unrealized Estimated</b> |              |               |                   |
| <b>Available for Sale:</b>          | <b>Cost</b>                                      | <b>Gains</b> | <b>Losses</b> | <b>Fair Value</b> |
| Mortgage-backed securities:         |  |              |               |                   |
| US Government-sponsored enterprises | \$304,106  | \$ 5,042     | \$2,155       | \$306,993         |
| US Government agency                | 78,408   | 1,269        | 547           | 79,130            |
| Private label                       | 2,713  | 762          | 11            | 3,464             |
| Obligations of states and           |  |              |               |                   |
| political subdivisions thereof      | 110,952  | 4,758        | 328           | 115,382           |
| Total                               | \$496,179  | \$11,831     | \$3,041       | \$504,969         |

**Impaired Securities:** The securities portfolio contains certain securities where amortized cost exceeds fair value, which June 30, 2016, amounted to an excess of \$604, or 0.1% of the amortized cost of the total securities portfolio. At December 31, 2015 this amount represented an excess of \$3,041, or 0.6% of the amortized cost of the total securities portfolio. As of June 30, 2016, unrealized losses on securities in a continuous unrealized loss position more than twelve-months amounted to \$336, compared with \$1,161 at December 31, 2015.

As a part of the Company's ongoing security monitoring process, the Company identifies securities in an unrealized loss position that could potentially be other-than-temporarily impaired ( OTTI ). If a decline in the fair value of an available for sale security is judged to be OTTI, a charge is recorded in pre-tax earnings equal to the estimated credit

losses inherent in the security.

Further information regarding impaired securities, OTTI securities and evaluation of securities for impairment is incorporated by reference to above Note 5 under the caption *Other Than Temporary Impairments on Investment Securities* of the interim unaudited consolidated financial statements in Part I, Item 1 of this report on Form 10-Q.

**Loans**

**Total Loans:** At June 30, 2016, total loans stood at \$1,049,022, compared with \$990,070 at December 31, 2015, representing an increase of \$58,952, or 6.0%.

The loan portfolio is primarily secured by real estate in the counties of Hancock, Washington, Knox, Kennebec and Sagadahoc, Maine.

The following table summarizes the components of the Bank's loan portfolio as of the dates indicated.

## LOAN PORTFOLIO SUMMARY

|  | June 30,<br>2016 | December 31,<br>2015 |
|--|------------------|----------------------|
| Commercial real estate mortgages             | \$ 390,033       | \$371,002            |
| Commercial and industrial                    | 80,749           | 79,911               |
| Commercial construction and land development | 25,467           | 24,926               |
| Agricultural and other loans to farmers      | 33,081           | 31,003               |
| Total commercial loans                       | 529,330          | 506,842              |
| Residential real estate mortgages            | 446,933          | 408,401              |
| Home equity loans                            | 49,330           | 51,530               |
| Other consumer loans                         | 6,946            | 7,949                |
| Total consumer loans                         | 503,209          | 467,880              |
| Tax exempt loans                             | 16,352           | 15,244               |
| Net deferred loan costs and fees             | 131              | 104                  |
| Total loans                                  | 1,049,022        | 990,070              |
| Allowance for loan losses                    | (9,891)          | (9,439)              |
| Total loans net of allowance for loan losses | \$1,039,131      | \$980,631            |

**Commercial Loans:** At June 30, 2016, total commercial loans stood at \$529,330, compared with \$506,842 at December 31, 2015, representing an increase of \$22,488, or 4.4%.

Commercial loan growth has generally been challenged by a still-soft economy, continued economic uncertainty, diminished demand, and strong competition for quality loans. Bank management attributes the growth of commercial loans to an effective business banking team, deep local market knowledge, sustained new business development efforts, and a resilient local economy that has been faring better than the nation as a whole.

**Consumer Loans:** At June 30, 2016, total consumer loans, which principally consisted of residential real estate mortgage loans, amounted to \$503,209, compared with \$467,880 at December 31, 2015, representing an increase of \$35,329, or 7.6%. The increase in consumer loans compared with year-end 2015 was aided by the purchase of residential mortgage loans. Loans that were originated and closed by the Bank during the first half of 2016 were largely offset by loan re-financings and scheduled principal amortization from the existing residential real estate loan portfolio.

***Credit Risk:*** Credit risk is managed through loan officer authorities, loan policies, and oversight from the Bank's Chief Credit Officer, the Bank's Management Loan Committee, the Board Risk Committee, and the Bank's Board of Directors. Management follows a policy of continually identifying, analyzing and grading credit risk inherent in the loan portfolio. An ongoing independent review, subsequent to management's review, of individual credits is performed by an independent loan review consulting firm, which reports to the Audit Committee of the Board of Directors.



As a result of management's ongoing review of the loan portfolio, loans are placed on non-accrual status, either due to the delinquent status of principal and/or interest, or a judgment by management that, although payments of principal and or interest are current, such action is prudent because collection in full of all outstanding principal and interest is in doubt. Loans are generally placed on non-accrual status when principal and or interest is 90 days overdue, or sooner, if judged appropriate by management. Consumer loans are generally charged-off when principal and/or interest payments are 120 days overdue, or sooner, if judged appropriate by management.

**Non-performing Loans:** Non-performing loans include loans on non-accrual status and loans past due 90 days or more and still accruing interest. The following table sets forth the details of non-performing loans as of the dates indicated:

### TOTAL NON-PERFORMING LOANS

|   | June 30,<br>2016 | December 31,<br>2015 |
|---|------------------|----------------------|
| Commercial real estate mortgages                      | \$1,087          | \$1,279              |
| Commercial and industrial loans                       | 190              | 292                  |
| Commercial construction and land development          | 813              | 1,111                |
| Agricultural and other loans to farmers               | ---              | 16                   |
| Total commercial loans                                | 2,090            | 2,698                |
| Residential real estate mortgages                     | 3,157            | 3,452                |
| Home equity loans                                     | 134              | 820                  |
| Other consumer loans                                  | 91               | 10                   |
| Total consumer loans                                  | 3,382            | 4,282                |
| Total non-accrual loans                               | 5,472            | 6,980                |
| Accruing loans contractually past due 90 days or more | 81               | 28                   |
| Total non-performing loans                            | \$5,553          | \$7,008              |
| Allowance for loan losses to non-performing loans     | 178.1%           | 134.7%               |
| Non-performing loans to total loans                   | 0.53%            | 0.71%                |
| Allowance to total loans                              | 0.94%            | 0.95%                |

At June 30, 2016, total non-performing loans amounted to \$5,553, compared with \$7,008 at December 31, 2015, representing a decline of \$1,455, or 20.8%.

Non-performing commercial real estate mortgages totaled \$1,087 at June 30, 2016, representing a decline of \$192, or 15.0%, compared with December 31, 2015. At June 30, 2016, non-performing commercial real estate mortgages were represented by ten business relationships, with outstanding balances ranging from \$31 to \$285.

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Non-performing commercial and industrial loans totaled \$190 at June 30, 2016, representing a decline of \$102, or 34.9%, compared with December 31, 2015. At June 30, 2016, non-performing commercial and industrial loans were represented by two business relationships, with outstanding balances ranging from less than \$20 to \$170.

Non-performing commercial construction and land development loans totaled \$813 at June 30, 2016, representing a decline of \$298, or 26.8%, compared with December 31, 2015. At June 30, 2016, non-performing commercial construction and land development loans were entirely represented by a commercial real estate loan to a local, non-profit affordable housing authority in support of an affordable housing project. This loan is

principally secured by the housing units from the project. The project is fully constructed and there is no construction risk associated with the loan. The primary source of repayment is the sale of the remaining housing units.

Non-performing residential real estate mortgages totaled \$3,157 at June 30, 2016, representing a decline of \$295, or 8.5%, compared with December 31, 2015. At June 30, 2016, non-performing residential real estate loans were represented by 38, conventional, 1-4 family mortgage loans, with outstanding balances ranging from \$11 to \$472.

Non-performing home equity loans totaled \$134 at June 30, 2016, representing a decline of \$686, or 83.7%, compared with December 31, 2015. At June 30, 2016, non-performing home equity loans were represented by seven relationships with outstanding balances ranging from \$10 to \$44.

While the level and mix of non-performing loans continued to reflect favorably on the overall quality of the Bank's loan portfolio as of June 30, 2016, Bank management is cognizant of the still-recovering real estate market and soft economic conditions overall. Future levels of non-performing loans may be influenced by economic conditions, including the impact of those conditions on the Bank's customers, including debt service levels, collateral values, tourism activity, consumer confidence and other factors existing at the time. Management believes the economic activity and conditions in the local real estate markets will continue to be significant determinants of the quality of the loan portfolio in future periods and, thus, the Company's results of operations and financial condition.

***Delinquencies and Potential Problem Loans:*** In addition to the non-performing loans discussed above, the Bank also has loans that are 30 to 89 days delinquent and still accruing. These loans amounted to \$4,402 and \$1,857 at June 30, 2016 and December 31, 2015, or 0.42% and 0.19% of total loans, respectively, net of any loans classified as non-performing that are within these delinquency categories. These loans and delinquency trends in general are considered in the evaluation of the allowance for loan losses and the related determination of the provision for loan losses.

Periodically, the Bank reviews the commercial loan portfolio for evidence of potential problem loans. Potential problem loans are loans that are currently performing in accordance with contractual terms, but where known information about possible credit problems of the borrower causes doubt about the ability of the borrower to comply with the loan payment terms and may result in disclosure of such loans as non-performing at some time in the future.

In addition to the non-performing and delinquent loans discussed above, at June 30, 2016, the Bank identified 32 commercial relationships totaling \$16,798 as potential problem loans, or 1.6% of total loans (i.e., substandard loans that are current and performing). At December 31, 2015, the Bank identified 32 commercial relationships totaling \$19,774 as potential problem loans, or 2.0% of total loans. Factors such as payment history, value of supporting collateral, and personal or government guarantees led the Bank to conclude that the current risk exposure on these potential problem loans did not warrant accounting for the loans as non-performing. Although in a performing status as of quarter-end, these loans exhibited certain risk factors, which have the potential to cause them to become non-performing at some point in the future.

***Allowance for Loan Losses:*** At June 30, 2016, the allowance for loan losses (the allowance ) stood at \$9,891, compared with \$9,439 at December 31, 2015, representing an increase of \$452, or 4.8%. The increase in the allowance from December 31, 2015 was largely attributed to loan growth, changes in the overall mix of non-performing and potential problem loans, and other qualitative considerations.

The allowance is available to absorb probable losses on loans. The determination of the adequacy of the allowance and provisioning for estimated losses is evaluated quarterly based on review of loans, with particular emphasis on non-performing and other loans that management believes warrant special consideration.

The allowance is maintained at a level that, in management's judgment, is appropriate for the amount of risk inherent in the current loan portfolio, and adequate to provide for estimated, probable losses. Allowances are established for specific impaired loans, a pool of reserves based on historical net loan charge-offs by loan types, and supplemental reserves that adjust historical net loss experience to reflect current economic conditions, industry specific risks, and other qualitative and environmental considerations impacting the inherent risk of loss in the current loan portfolio.

Specific allowances for impaired loans are determined based upon a discounted cash flows analysis, or as appropriate, a collateral shortfall analysis. The amount of collateral dependent impaired loans totaled \$2,769 as of June 30, 2016, compared with \$1,999 as of December 31, 2015. The related allowances for loan losses on these loans amounted to \$307 as of June 30, 2016, compared with \$312 as of December 31, 2015.

Management recognizes that early and accurate recognition of risk is the best means to reduce credit losses. The Bank employs a comprehensive risk management structure to identify and manage the risk of loss. For consumer loans, the Bank identifies loan delinquency beginning at 10-day delinquency and provides appropriate follow-up by written correspondence or personal contact. Non-residential mortgage consumer loan losses are recognized no later than the point at which a loan is 120 days past due. Residential mortgage losses are recognized during the foreclosure process, or sooner, when that loss is quantifiable and reasonably assured. For commercial loans, the Bank applies a risk grading system, which stratifies the portfolio and allows management to focus appropriate efforts on the highest risk components of the portfolio. The risk grades include ratings that correlate substantially with regulatory definitions of Pass, Other Assets Especially Mentioned, Substandard, Doubtful, and Loss.

While management uses available information to recognize losses on loans, changing economic conditions and the economic prospects of the borrowers may necessitate future additions or reductions to the allowance. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance, which also may necessitate future additions or reductions to the allowance, based on information available to them at the time of their examination.

The following table details changes in the allowance and summarizes loan loss experience by loan type for the six months ended June 30, 2016 and 2015.

**ALLOWANCE FOR LOAN LOSSES****SIX MONTHS ENDED****JUNE 30, 2016 AND 2015**

|  | <b>2016</b> | <b>2015</b> |
|--|-------------|-------------|
| Balance at beginning of period               | \$9,439     | \$8,969     |
| <b>Charge-offs:</b>                          |             |             |
| Commercial real estate mortgages             | 34          | 206         |
| Commercial and industrial                    | 90          | 288         |
| Commercial construction and land development | ---         | ---         |
| Agricultural and other loans to farmers      | ---         | 18          |
| Residential real estate mortgages            | 122         | 70          |
| Other consumer loans                         | 17          | 25          |
| Home equity loans                            | ---         | 351         |
| Tax exempt loans                             | ---         | ---         |
| <b>Total charge-offs</b>                     | <b>263</b>  | <b>958</b>  |
| <b>Recoveries:</b>                           |             |             |
| Commercial real estate mortgages             | 13          | \$ 39       |
| Commercial and industrial loans              | 4           | 2           |
| Commercial construction and land development | ---         | ---         |
| Agricultural and other loans to farmers      | 40          | 12          |
| Residential real estate mortgages            | 28          | 129         |
| Other consumer loans                         | 13          | 11          |
| Home equity loans                            | 2           | ---         |
| Tax exempt loans                             | ---         | ---         |
| <b>Total recoveries</b>                      | <b>100</b>  | <b>193</b>  |
| <b>Net charge-offs</b>                       | <b>163</b>  | <b>765</b>  |
| Provision charged to operations              | 615         | 895         |
| Balance at end of period                     | \$9,891     | \$9,099     |

For the six months ended June 30, 2016, total net loan charge-offs amounted to \$163, or annualized net charge-offs to average loans outstanding of 0.03%, compared with \$765 and 0.16%, respectively, for the first half of 2015.

General allowances for loan losses account for the risk and estimated loss inherent in certain pools of industry and geographic loan concentrations within the loan portfolio. There were no material changes in loan concentrations during the six months ended June 30, 2016.

Based upon the process employed and giving recognition to all attendant factors associated with the loan portfolio, Company management believes the allowance for loan losses at June 30, 2016 is appropriate for the amount of risk inherent in the current loan portfolio and adequate to provide for estimated probable losses.

Further information regarding loans and the allowance for loan losses, is incorporated by reference to above Note 8, *Loans and Allowance for Loan Losses*, of the interim unaudited consolidated financial statements in Part I, Item 1 of this report on Form 10-Q.

## Bank Owned Life Insurance

Bank-owned life insurance ( BOLI ) represents life insurance on the lives of certain current and retired employees who had provided positive consent allowing the Bank to be the beneficiary of such policies. Increases in the cash value of the policies, as well as insurance proceeds received in excess of the cash value, are recorded in other non-interest income, and are not subject to income taxes. The cash surrender value of the BOLI is included on the Company's consolidated balance sheet.

The Company reviews the financial strength of the insurance carrier prior to the purchase of BOLI and quarterly thereafter. At June 30, 2016, the Bank had four BOLI carriers which were credit rated by Standard & Poor's as AA- or higher (i.e., high grade investments ).

At June 30, 2016, total BOLI amounted to \$24,131, compared with \$23,747 at December 31, 2015, representing an increase of \$384, or 1.6%. The increase in BOLI was attributed to increases in the cash surrender value of the BOLI policies.

## Deposits

Historically, the banking business in the Bank's market area has been seasonal, with lower deposits in the winter through late spring and higher deposits in summer and autumn. These seasonal swings have been fairly predictable and have not had a materially adverse impact on the Bank. Seasonal swings in deposits have been typically absorbed by the Bank's strong liquidity position, including borrowing capacity from the FHLB of Boston, brokered certificates of deposit obtained from the national market and cash flows from the securities portfolio.

At June 30, 2016, total deposits stood at \$989,816, compared with \$942,787 at December 31, 2015, representing an increase of \$47,029, or 5.0%. The Bank's non-maturity deposit accounts posted a combined seasonal decline of \$13,100, or 2.4%, while total time deposits increased \$60,129, or 15.2%, compared with December 31, 2015. The increase in time deposits was attributed to deposits obtained from the national market, which were utilized to replace seasonal deposit outflows as well as funding earning asset growth.

## Borrowed Funds

Borrowed funds principally consist of advances from the FHLB of Boston (the FHLB ) and, to a lesser extent, securities sold under agreements to repurchase and Fed funds purchased. Advances from the FHLB are secured by stock in the FHLB, investment securities, blanket liens on qualifying mortgage loans and home equity loans, and



certain commercial real estate loans.

The Bank utilizes borrowed funds to leverage its strong capital position and support its earning asset portfolios. Borrowed funds are principally utilized to support the Bank's investment securities portfolio and, to a lesser extent, fund loan growth. Borrowed funds also provide a means to help manage balance sheet interest rate risk, given the Bank's ability to select desired amounts, terms and maturities on a daily basis.

At June 30, 2016, total borrowings amounted to \$525,102, compared with \$474,791 at December 31, 2015, representing an increase of \$50,311, or 10.6%. The increase in borrowings was utilized to help support earning asset growth as well as replacing seasonal deposit outflows.

## Capital Resources

Consistent with its long-term goal of operating a sound and profitable organization, the Company maintained its strong capital position and continued to be a well-capitalized bank holding company according to applicable regulatory standards. Management believes this to be vital in promoting depositor and investor confidence and providing a solid foundation for future growth.

**Capital Ratios:** The Company and the Bank are subject to the risk-based capital guidelines administered by the Company's and the Bank's principal regulators. The risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies, to account for off-balance sheet exposure and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of risk-weighted assets and off-balance sheet items. Effective January 1, 2015, the Company and the Bank adopted the Basel III capital adequacy rules which, among other changes added a new risk-weighted capital measure Common Equity Tier I ( CETI ), as well as a phased in capital conservation buffer. For further information regarding the Basel III capital rules as they related to our Annual Report on Form 10-K, Item I, Supervision and Regulation, *Capital Adequacy and Prompt Corrective Action*. The new Basel III capital adequacy guidelines require all banks and bank holding companies to maintain minimum capital ratios of:

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Common Equity Tier I of 5.125%

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Total risk-based capital to risk-weighted assets of 8.625%

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Tier I capital to total risk-weighted assets of 6.625%

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Tier I capital to average assets ( Leverage Ratio ) of 4.0%

Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a material adverse effect on the Company's financial statements.

As depicted in the table below, as of June 30, 2016, the Company and the Bank were considered *well-capitalized* under the regulatory framework for prompt corrective action. Under the Basel III capital adequacy guidelines, a *well-capitalized* institution must maintain the following capital ratios:

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Common Equity Tier I of 6.5%

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Total risk-based capital to risk-weighted assets of 10.0%

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Tier I capital to total risk-weighted assets of 8.0%

.

Tier I capital to average assets ( Leverage Ratio ) of 5.0%

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The following tables set forth the Company's and the Bank's regulatory capital at June 30, 2016 and December 31, 2015, under the rules applicable at that date.

| As of June 30, 2016  | Well Capitalized |       | Actual    |        | Basel III |        | Fully Phased-In |       |
|--|------------------|-------|-----------|--------|-----------|--------|-----------------|-------|
|  | Amount           | Ratio | Amount    | Ratio  | Amount    | Ratio  | Amount          | Ratio |
| <b>Total Capital</b><br>(To Risk-Weighted Assets)                                      |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$166,680 | 17.09% | \$84,122  | 8.625% | \$102,410       | 10.5% |
| Bank   | \$97,440         | 10.0% | \$168,786 | 17.32% | \$84,042  | 8.625% | \$102,312       | 10.5% |
| <b>Common Equity Tier 1</b><br>(To Risk-Weighted Assets)                               |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$151,551 | 15.54% | \$49,986  | 5.125% | \$68,273        | 7.0%  |
| Bank   | \$63,336         | 6.5%  | \$153,657 | 15.77% | \$49,938  | 5.125% | \$68,208        | 7.0%  |
| <b>Tier 1 Capital</b><br>(To Risk-Weighted Assets)                                     |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$151,551 | 15.54% | \$64,616  | 6.625% | \$82,903        | 8.5%  |
| Bank   | \$77,952         | 8.0%  | \$153,657 | 15.77% | \$64,554  | 6.625% | \$82,824        | 8.5%  |
| <b>Leverage Capital Ratio</b><br>Total Capital<br>(To Total Assets for Leverage Ratio) |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$151,551 | 9.21%  | \$65,855  | 4.000% | \$65,855        | 4.0%  |
| Bank   | \$82,277         | 5.0%  | \$153,657 | 9.34%  | \$65,822  | 4.000% | \$65,822        | 4.0%  |
| As of December 31, 2015  | Well Capitalized |       | Actual    |        | Basel III |        | Fully Phased-In |       |
|  | Amount           | Ratio | Amount    | Ratio  | Amount    | Ratio  | Amount          | Ratio |
| <b>Total Capital</b><br>(To Risk-Weighted Assets)                                      |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$160,042 | 17.12% | \$74,793  | 8.0%   | \$98,166        | 10.5% |
| Bank   | \$93,391         | 10.0% | \$161,905 | 17.34% | \$74,713  | 8.0%   | \$98,060        | 10.5% |
| <b>Common Equity Tier 1</b><br>(To Risk-Weighted Assets)                               |                  |       |           |        |           |        |                 |       |
| Consolidated   | N/A              |       | \$145,400 | 15.55% | \$42,071  | 4.5%   | \$65,444        | 7.0%  |
| Bank   | \$60,704         | 6.5%  | \$147,263 | 15.77% | \$42,026  | 4.5%   | \$65,374        | 7.0%  |

**Tier 1 Capital**

(To Risk-Weighted Assets)

|              |          |           |           |          |          |           |           |      |
|--------------|----------|-----------|-----------|----------|----------|-----------|-----------|------|
| Consolidated | N/A      | \$145,400 | 15.55%    | \$56,095 | 6.0%     | \$ 79,468 | 8.5%      |      |
| Bank         | \$74,713 | 8.0%      | \$147,263 | 15.77%   | \$56,035 | 6.0%      | \$ 79,382 | 8.5% |

**Leverage Capital Ratio**

Total Capital

(To Total Assets for Leverage

Ratio)

|              |          |           |           |          |          |           |           |      |
|--------------|----------|-----------|-----------|----------|----------|-----------|-----------|------|
| Consolidated | N/A      | \$145,400 | 9.37%     | \$62,087 | 4.0%     | \$ 62,087 | 4.0%      |      |
| Bank         | \$77,563 | 5.0%      | \$147,263 | 9.49%    | \$62,050 | 4.0%      | \$ 62,050 | 4.0% |

**Trends, Events or Uncertainties:** There are no known trends, events or uncertainties, nor any recommendations by any regulatory authority, that are reasonably likely to have a material effect on the Company's capital resources, liquidity, or financial condition.

**Cash Dividends:** The Company's principal source of funds to pay cash dividends and support its commitments is derived from Bank operations.

The Company paid a regular cash dividend of 27.0 cents per share of common stock in the second quarter of 2016, representing an increase of 2.0 cents, or 8.0%, compared with the second quarter of 2015.

The Company's Board of Directors recently declared a third quarter 2016 regular cash dividend of 27.5 cents per share of Company common stock, representing an increase of 2.0 cents, or 7.8%, compared with the third quarter of 2015. The quarterly cash dividend is payable to all Company shareholders of record as of the close of business August 15, 2016, and will be paid on September 15, 2016. This represented the twenty-first consecutive quarter where the Company increased its quarterly cash dividend to shareholders.

**Stock Repurchase Plan:** In August 2008, the Company's Board of Directors approved a program to repurchase up to 450,000 shares of the Company's common stock, or approximately 10.2% of the shares then currently outstanding. The stock repurchase program became effective as of August 21, 2008, and was authorized to continue for a period of up to twenty-four consecutive months. In August of 2010, the Company's Board of Directors authorized the continuance of this program through August 17, 2012. In August of 2012, the Company's Board of Directors authorized the continuance of this program through August 17, 2014. In July of 2014, the Company's Board of Directors authorized the continuance of this program through August 17, 2016. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time, or from time to time, without prior notice and may be made in the open market or through privately negotiated transactions.

As of June 30, 2016, the Company had repurchased 173,363 shares of stock under this plan, at a total cost of \$3,449 and an average price of \$19.89 per share. During the six months ended June 30, 2016, the Company repurchased 14,950 shares under the plan. The Company records repurchased shares as treasury stock.

### **Off-Balance Sheet Arrangements**

The Company is, from time to time, a party to certain off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, that may be considered material to investors.

**Standby Letters of Credit:** The Bank guarantees the obligations or performance of certain customers by issuing standby letters of credit to third parties. These letters of credit are sometimes issued in support of third party debt. The risk involved in issuing standby letters of credit is essentially the same as the credit risk involved in extending loan facilities to customers, and they are subject to the same origination, portfolio maintenance and management procedures in effect to monitor other credit products. The amount of collateral obtained, if deemed necessary by the Bank upon issuance of a standby letter of credit, is based upon management's credit evaluation of the customer.

At June 30, 2016 and December 31, 2015, commitments under existing standby letters of credit totaled \$385. The fair value of the standby letters of credit was not significant as of the foregoing dates.

**Off-Balance Sheet Risk**

The Bank is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and certain financial derivative instruments; namely, interest rate cap agreements.

***Commitments to Extend Credit:*** Commitments to extend credit represent agreements by the Bank to lend to a customer provided there is no violation of any condition established in the contract. These commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of these commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each

customer's creditworthiness on a case-by-case basis using the same credit policies as it does for its balance sheet instruments, such as loans. The amount of collateral obtained, if deemed necessary by the Bank upon the issuance of commitment, is based on management's credit evaluation of the customer.

The following table summarizes the Bank's commitments to extend credit as of June 30, 2016 and December 31, 2015:

|  | <b>June 30,</b> | <b>December 31,</b> |
|--|-----------------|---------------------|
|  | <b>2016</b>     | <b>2015</b>         |
| Commitments to originate loans             | \$ 25,047       | \$ 41,529           |
| Unused lines of credit                     | 93,974          | 97,283              |
| Un-advanced portions of construction loans | 24,180          | 12,719              |
| Total                                      | \$143,201       | \$151,531           |

**Financial Derivative Instruments:** As part of its overall asset and liability management strategy, the Bank periodically uses derivative instruments to minimize significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The Bank's interest rate risk management strategy involves modifying the re-pricing characteristics of certain assets and liabilities so that change in interest rates does not have a significant adverse effect on net interest income. Derivative instruments that management periodically uses as part of its interest rate risk management strategy include interest rate swap agreements, interest rate floor agreements, and interest rate cap agreements.

At June 30, 2016 and December 31, 2015, the Bank had four outstanding, off-balance sheet, derivative instruments. These derivative instruments were interest rate cap agreements, with notional principal amounts totaling \$90,000. The notional amounts of the financial derivative instruments do not represent exposure to credit loss. The Bank is exposed to credit loss only to the extent the counter-party defaults in its responsibility to pay interest under the terms of the agreements. The credit risk in derivative instruments is mitigated by entering into transactions with highly-rated counterparties that management believes to be creditworthy and by limiting the amount of exposure to each counter-party. At June 30, 2016, the Bank's derivative instrument counterparties were credit rated AA by the major credit rating agencies. The interest rate cap agreements were purchased by the Bank to limit its exposure to rising interest rates and were designated as cash flow hedges.

Further information covering the Bank's derivative instruments is incorporated by reference to Part I, Item 1, Note 11 of the Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

## Liquidity



Liquidity is measured by the Company's ability to meet short-term cash needs at a reasonable cost or minimal loss. The Company seeks to obtain favorable sources of liabilities and to maintain prudent levels of liquid assets in order to satisfy varied liquidity demands. Besides serving as a funding source for maturing obligations, liquidity provides flexibility in responding to customer-initiated needs. Many factors affect the Company's ability to meet liquidity needs, including variations in the markets served by its network of offices, its mix of assets and liabilities, reputation and credit standing in the marketplace, and general economic conditions.

The Bank actively manages its liquidity position through target ratios established under its asset liability management policy. Continual monitoring of these ratios, both historical and through forecasts under multiple rate scenarios, allows the Bank to employ strategies necessary to maintain adequate liquidity. A portion of the Bank's deposit base has been historically seasonal in nature, with balances typically declining in the winter months through late spring, during which period the Bank's liquidity position tightens.

The Bank uses a basic surplus model to measure its liquidity over 30 and 90-day time horizons. The relationship between liquid assets and short-term liabilities that are vulnerable to non-replacement are routinely monitored. The Bank's general policy is to maintain a liquidity position of 4% or higher of total assets over the 30-day horizon. At June 30, 2016, liquidity, as measured by the basic surplus/deficit model, was 10.0% over both the 30-day horizon and the 90-day horizon.

At June 30, 2016, the Bank had unused lines of credit and net unencumbered qualifying collateral availability to support its credit line with the FHLB of Boston approximating \$221 million. The Bank also had capacity to borrow funds on a secured basis utilizing the Borrower-In-Custody ( BIC ) program and the Discount Window at the Federal Reserve Bank of Boston. At June 30, 2016, the Bank's available secured line of credit at the Federal Reserve Bank of Boston stood at \$142,953, or 8.5% of the Bank's total assets. The Bank also has access to the national brokered deposit market, and periodically uses this funding source to bolster its on-balance sheet liquidity position.

The Bank maintains a liquidity contingency plan approved by the Bank's Board of Directors. This plan addresses the steps that would be taken in the event of a liquidity crisis, and identifies other sources of liquidity available to the Company. The Company believes that the level of liquidity is sufficient to meet current and future funding requirements. However, changes in economic conditions, including consumer savings habits and availability or access to the brokered deposit market could potentially have a significant impact on the Company's liquidity position.

### Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates/prices, such as interest rates, foreign currency exchange rates, commodity prices and equity prices. Interest rate risk is the most significant market risk affecting the Company. Other types of market risk do not arise in the normal course of the Company's business activities.

**Interest Rate Risk:** Interest rate risk can be defined as an exposure to movement in interest rates that could have an adverse impact on the Bank's net interest income. Interest rate risk arises from the imbalance in the re-pricing, maturity and/or cash flow characteristics of assets and liabilities. Management's objectives are to measure, monitor and develop strategies in response to the interest rate risk profile inherent in the Bank's balance sheet. The objectives in managing the Bank's balance sheet are to preserve the sensitivity of net interest income to actual or potential changes in interest rates, and to enhance profitability through strategies that promote sufficient reward for understood and controlled risk.

The Bank's interest rate risk measurement and management techniques incorporate the re-pricing and cash flow attributes of balance sheet and off balance sheet instruments as they relate to current and potential changes in interest rates. The level of interest rate risk, measured in terms of the potential future effect on net interest income, is determined through the use of modeling and other techniques under multiple interest rate scenarios. Interest rate risk is evaluated in depth on a quarterly basis and reviewed by the Asset Liability Management Committee ( ALCO ) and the Bank's Board of Directors.

The Bank's Asset Liability Management Policy, approved annually by the Bank's Board of Directors, establishes interest rate risk limits in terms of variability of net interest income under rising, flat, and decreasing rate scenarios. It is the role of ALCO to evaluate the overall risk profile and to determine actions to maintain and achieve a posture consistent with policy guidelines.

The Bank utilizes an interest rate risk model widely recognized in the financial industry to monitor and measure interest rate risk. The model simulates the behavior of interest income and expense of all balance sheet and off-balance sheet instruments, under different interest rate scenarios together with a dynamic future balance sheet. Interest rate risk is measured in terms of potential changes in net interest income based upon shifts in the yield curve.

The interest rate risk sensitivity model requires that assets and liabilities be broken down into components as to fixed, variable, and adjustable interest rates, as well as other homogeneous groupings, which are segregated as to maturity and type of instrument. The model includes assumptions about how the balance sheet is likely to evolve through time and in different interest rate environments. The model uses contractual re-pricing dates for variable products, contractual maturities for fixed rate products, and product specific assumptions for deposit accounts, such as money market accounts, that are subject to re-pricing based on current market conditions. Re-pricing margins are also determined for adjustable rate assets and incorporated in the model. Investment securities and borrowings with call

provisions are examined on an individual basis in each rate environment to estimate the likelihood of a call. Prepayment assumptions for mortgage loans and mortgage backed securities are developed from industry median estimates of prepayment speeds, based upon similar coupon ranges and seasoning. Cash flows and maturities are then determined, and for certain assets, prepayment assumptions are estimated under different interest rate scenarios. Interest income and interest expense are then simulated under several hypothetical interest rate conditions including:

.

A flat interest rate scenario in which current prevailing rates are locked in and the only balance sheet fluctuations that occur are due to cash flows, maturities, new volumes, and re-pricing volumes consistent with this flat rate assumption.

A 200 basis point rise or decline in interest rates applied against a parallel shift in the yield curve over a twelve-month period together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.

Various non-parallel shifts in the yield curve, including changes in either short-term or long-term rates over a twelve-month horizon, together with a dynamic balance sheet anticipated to be consistent with such interest rate changes.

An extension of the foregoing simulations to each of two, three, four and five year horizons to determine the interest rate risk with the level of interest rates stabilizing in years two through five. Even though rates remain stable during this two to five year time period, re-pricing opportunities driven by maturities, cash flow, and adjustable rate products will continue to change the balance sheet profile for each of the rate conditions.

Changes in net interest income based upon the foregoing simulations are measured against the flat interest rate scenario and actions are taken to maintain the balance sheet interest rate risk within established policy guidelines.

The following table summarizes the Bank's net interest income sensitivity analysis as of June 30, 2016, over one and two-year horizons and under rising and declining interest rate scenarios. In light of the Federal Funds rate of 0.25% to 0.50% and the two-year U.S. Treasury Note of 0.63% on the date presented, the analysis incorporates a declining interest rate scenario of 100 basis points, rather than the 200 basis points, as would traditionally be the case.

## **INTEREST RATE RISK**

### **CHANGE IN NET INTEREST INCOME FROM THE FLAT RATE SCENARIO**

JUNE 30, 2016

|                          | <b>-100 Basis<br/>Points Parallel<br/>Yield Curve<br/>Shift</b> | <b>+200 Basis<br/>Points Parallel<br/>Yield Curve<br/>Shift</b> |
|--------------------------|---|---|
| <b>Year 1</b>            |   |   |
| Net interest income (\$) | \$ (192)  | \$ (409)  |
| Net interest income (%)  | -0.43%  | -0.91%  |
| <b>Year 2</b>            |   |   |
| Net interest income (\$) | \$(3,449)   | \$(3,092)   |
| Net interest income (%)  | -7.65%  | -6.86%  |

As more fully discussed below, the June 30, 2016, interest rate sensitivity modeling results indicate that the Bank's balance sheet was moderately liability sensitive over the one and two-year horizons (i.e., moderately exposed to rising interest rates).

Assuming short-term and long-term interest rates decline 100 basis points from current levels (i.e., a parallel yield curve shift) and the Bank's balance sheet structure and size remain at current levels, management believes net interest income will remain relatively stable over the one year horizon followed by a meaningful decline over the two-year horizon, as declining earning assets yields outpace reductions in funding costs. Should the yield curve steepen as rates fall, the model suggests that accelerated earning asset prepayments will slow, resulting in a more stabilized level of net interest income. Management anticipates that moderate to strong earning asset growth will be needed to meaningfully increase the Bank's current level of net interest income should both long-term and short-term interest rates decline in parallel.

Assuming the Bank's balance sheet structure and size remain at current levels and the Federal Reserve increases short-term interest rates by 200 basis points with the balance of the yield curve shifting in parallel with these increases, management believes net interest income will remain relatively stable over the one year horizon, followed by a meaningful decline over the two year horizon as increased funding costs outpace increases in earning asset yields. The interest rate sensitivity simulation model suggests that as interest rates rise, the Bank's funding costs will initially re-price disproportionately with earning asset yields to a moderate degree. As funding costs begin to stabilize early in the third year of the simulation, the model suggests that the earning asset portfolios will continue to re-price at prevailing interest rate levels and cash flows from the Bank's earning asset portfolios will be reinvested into higher yielding earning assets, resulting in a widening of spreads and a stabilization of net interest income over the three year horizon and beyond. Management believes moderate to strong earning asset growth will be necessary to meaningfully increase the current level of net interest income over the one-year and two-year horizons should short-term and long-term interest rates rise in parallel.

Interest rates plummeted during 2008 and have remained historically low ever since, as the global economy slowed at unprecedented levels, unemployment levels soared, delinquencies on all types of loans increased along with decreased consumer confidence and dramatic declines in housing prices. Management believes the most significant ongoing factor affecting market risk exposure and the impact on net interest income continues to be the slow and extended recovery from the severe nationwide recession and the U.S. Government's extraordinary responses, including a variety of government stimulus programs and quantitative easing strategies.

The Federal Reserve has maintained short-term interest rates at historically low levels for an extended period of time, threatening net interest income. Net interest income exposure is also significantly affected by the shape and level of the U.S. Government securities and interest rate swap yield curve, and changes in the size and composition of the Bank's loan, investment and deposit portfolios.

The preceding sensitivity analysis does not represent a Company forecast and should not be relied upon as being indicative of expected operating results. These hypothetical estimates are based upon numerous assumptions including: the nature and timing of interest rate levels and yield curve shape, prepayment speeds on loans and securities, deposit rates, pricing decisions on loans and deposits, reinvestment or replacement of asset and liability cash flows, and renegotiated loan terms with borrowers. While assumptions are developed based upon current economic and local market conditions, the Company cannot make any assurances as to the predictive nature of these assumptions including how customer preferences or competitor influences might change.

As market conditions vary from those assumed in the sensitivity analysis, actual results may also differ due to: prepayment and refinancing levels deviating from those assumed; the impact of interest rate change caps or floors on adjustable rate assets; the potential effect of changing debt service levels on customers with adjustable rate loans; depositor early withdrawals and product preference changes; and other such variables. The sensitivity analysis also does not reflect additional actions that the Bank's SET and Board of Directors might take in responding to or anticipating changes in interest rates, and the anticipated impact on the Bank's net interest income.

**Item 4. CONTROLS AND PROCEDURES**

Company management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this quarterly report. Based on such evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports it files or submits under



the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and regulations and are operating in an effective manner.

No change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15(d)-15(f) under the Securities Exchange Act of 1934) occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1: Legal Proceedings**

The Company and its subsidiaries are parties to certain ordinary routine litigation incidental to the normal conduct of their respective businesses, which in the opinion of management based upon currently available information will have no material adverse effect on the Company's consolidated financial statements.

### **Item 1A: Risk Factors**

An investment in the Company's common stock is subject to risk inherent to our business. We believe the risk factors identified in our Annual Report on Form 10-K for the year ended December 31, 2015, continue to represent the most significant risks to our future results of operations and financial condition. Additional risk factors that could also impact our future results of operations and financial condition include failure to complete the proposed LSBG Merger, the imposition of adverse regulatory conditions in connection with regulatory approval of the proposed LSBG Merger, disruption to the parties' businesses as a result of the announcement and pendency of the LSBG Merger, the inability to realize expected cost savings or to implement integration plans and other adverse consequences associated with the LSBG Merger. Please refer to the Company's risk factors listed in Part 1, Item 1A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015

### **Item 2: Unregistered Sales of Equity Securities and Use of Proceeds**

(a) None.

(b) None.

(c) Shares purchase activity during the three months ended June 30, 2016 was as follows:

| <b>Period</b>    | <b>(a)</b><br><b>Total Number<br/>of Shares<br/>Purchased</b> | <b>(b)</b><br><b>Average Price<br/>Paid per Share</b> | <b>(c)</b><br><b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Plans<br/>or Programs</b> | <b>(d)</b><br><b>Maximum Number<br/>of Shares that May<br/>Yet Be Purchased<br/>Under the Plans or<br/>Programs (1)</b> |
|------------------|---|---|---|---|
| April 1-30, 2016 | 8,698   | \$33.32   | 8,698   | 276,637   |
| May 1-31, 2016   | ---   | ---   | ---   | 276,637   |
| June 1-30, 2016  | ---   | ---   | ---   | 276,637   |

Additional information regarding the Company's Stock Repurchase Plan is incorporated herein by reference to Part I, Item 2 of this Report on Form 10-Q under the captions, Financial Condition, Capital Resources and Stock Repurchase Plan.

**Item 3: Defaults Upon Senior Securities**

None.

**Item 4: Mine Safety Disclosures**

Not applicable.

**Item 5: Other Information**

None.

**Item 6: Exhibits**

The exhibits required to be furnished as part of this Quarterly Report on Form 10-Q are listed in the Exhibit Index hereto and are incorporated herein by reference.

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**BAR HARBOR BANKSHARES**

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(Registrant)

/s/Curtis C. Simard

Date: August 8, 2016

Curtis C. Simard  
President & Chief Executive Officer

/s/Gerald Shencavitz

Date: August 8, 2016

Gerald Shencavitz  
Executive Vice President, Chief Financial Officer  
& Principal Accounting Officer

**Exhibit Index**

- 2.1 Agreement and Plan of Merger, dated as of May 5, 2016, by and between Bar Harbor Bankshares and Lake Sunapee Bank Group (incorporated herein by reference to Exhibit 2.1 to Form 8-K filed with the Commission on May 9, 2016).
- 3.1 Articles of Incorporation, as amended to date (incorporated herein by reference to Form 10-Q, Part II, Item 6, Exhibit 3.1, filed with the Commission on November 5, 2015).
- 3.2 Bylaws, as amended to date (incorporated herein by reference to Form 8-K, Item 5.03, Exhibit 3.2, filed with the Commission on November 29, 2011).
- 4.1 Certificate of Designations, Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated herein by reference to Form 8-K, Exhibit 3.1, filed with the Commission on January 21, 2009).
- 4.2 4,177,285 number of estimated shares of Company common stock par value, \$2.00 per share, to be issued upon completion of the LSBG Merger (incorporated herein by reference to Form S-4, filed with the Commission on July 19, 2016).
- 10.1\* Consulting Agreement with Interim Chief Financial Officer Bradford Kopp, (incorporated herein by reference to Exhibit 10.1 to Form 8-K filed with the Commission on June 16, 2016).
- 11.1 Statement re computation of per share earnings (data required by SFAS No. 128, Earnings Per Share, is provided in Note 6 to the consolidated financial statements in this report on Form 10-Q and incorporated herein by reference thereto).
- 31.1 Certification of the Chief Executive Officer under Rule 13a-14(a)/15d-14(a) (filed herewith).
- 31.2 Certification of the Chief Financial Officer under Rule 13a-14(a)/15d-14(a) (filed herewith).
- 32.1 Certification of Chief Executive Officer under 18 U.S.C. Section 1350 (furnished herewith).
- 32.2 Certification of Chief Financial Officer under 18 U.S.C. Section 1350 (furnished herewith).
- 101 Financial statements from the quarterly report on Form 10-Q of Bar Harbor Bankshares for the period ended June 30, 2016, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Shareholders Equity and Comprehensive Income, (iv) the Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements.

\*Management Contract or Compensatory Agreement

