

SHORE BANCSHARES INC
Form 10-K/A
April 09, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

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

For the Year Ended December 31, 2017

Commission File No. 0-22345

SHORE BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Maryland 52-1974638
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

28969 Information Lane, Easton, Maryland 21601

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(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (410) 763-7800

Securities Registered pursuant to Section 12(b) of the Act:

Title of Each Class:	Name of Each Exchange on Which Registered:
Common stock, par value \$.01 per share	Nasdaq Global Select Market

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
" Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 16(d) of the Act. " Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K "

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company", and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

Explanatory Note

This Amendment No. 1 to the Annual Report on Form 10-K (this “Form 10-K/A”) amends the Annual Report on Form 10-K for the fiscal year ended December 31, 2017, originally filed with the Securities and Exchange Commission (the “SEC”) on March 16, 2018 (the “Original Filing”), by Shore Bancshares, Inc. (the “Company”). Although referenced in the opinion of the Company’s independent auditors with respect to the financial statements, the full text of the opinion of the Company’s independent auditor with respect to its internal control over financial reporting was inadvertently omitted from the Original Filing.

Pursuant to Rule 12b-15 promulgated under the Securities and Exchange Act of 1934, as amended, we have included the entire text of Part II, Item 8 in this Form 10-K/A. Part IV, Item 15 has been included to reflect the consents of Yount, Hyde & Barbour, P.C., Dixon Hughes Goodman LLP and Stegman & Company, and updated certifications of the Company’s Chief Executive Officer and Chief Financial Officer.

Except as described above, this Form 10-K/A does not revise, amend, update or in any way affect any information or disclosures contained in the Original Filing, and we have not updated the disclosures contained herein to reflect events that occurred at a later date.

Item 8. Financial Statements and Supplementary Data.

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MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Shore Bancshares, Inc. (the "Company") is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The Company's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and, as such, include some amounts that are based on the best estimates and judgments of management.

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. This internal control system is designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of the Company's financial reporting and the preparation and presentation of financial statements for external reporting purposes in conformity with accounting principles generally accepted in the United States of America, as well as to safeguard assets from unauthorized use or disposition. The system of internal control over financial reporting is evaluated for effectiveness by management and tested for reliability through a program of internal audit with actions taken to correct potential deficiencies as they are identified. Because of inherent limitations in any internal control system, no matter how well designed, misstatement due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2017 based upon criteria set forth in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 COSO Framework).

Based on this assessment and on the foregoing criteria, management has concluded that, as of December 31, 2017, the Company's internal control over financial reporting is effective. Yount, Hyde & Barbour, the Company's independent registered public accounting firm that audited the financial statements included in this annual report, has issued a report on the Company's internal control over financial reporting, which appears on the following page.

March 16, 2018

/s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

/s/ Edward C. Allen
Edward C. Allen
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of Shore Bancshares, Inc. and subsidiaries (the Company) as of December 31, 2017, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the year ended December 31, 2017, and the related notes to the consolidated financial statements (collectively, the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the results of its operations and its cash flows for the year ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 16, 2018 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material

misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Yount, Hyde & Barbour, P.C.

We have served as the Company's
auditor since 2017.

Winchester, Virginia
March 16, 2018

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

Opinion on the Internal Control Over Financial Reporting

We have audited Shore Bancshares, Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheet as of December 31, 2017, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the year ended December 31, 2017, and the related notes to the consolidated financial statements of the Company and our report dated March 16, 2018 expressed an unqualified opinion.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying *Management's Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the

PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia

March 16, 2018

Report Of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Shore Bancshares, Inc.

We have audited the accompanying consolidated balance sheet of Shore Bancshares, Inc. (the “Company”) as of December 31, 2016, and the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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

/s/ Dixon Hughes Goodman LLP

Baltimore, Maryland

March 16, 2017

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Shore Bancshares, Inc.

We have audited the accompanying consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows of Shore Bancshares, Inc. (the "Company") for the year ended December 31, 2015. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit also included performing such other procedures as we considering necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Shore Bancshares, Inc. for the year ended December 31, 2015 in conformity with accounting principles generally accepted in the United States of America.

/s/ Stegman & Company

Baltimore, Maryland

March 11, 2016

SHORE BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS

December 31,

(In thousands, except share data)	2017	2016
ASSETS		
Cash and due from banks	\$21,534	\$14,596
Interest-bearing deposits with other banks	10,286	61,342
Cash and cash equivalents	31,820	75,938
Investment securities:		
Available-for-sale, at fair value	196,955	163,902
Held to maturity, at amortized cost - fair value of \$6,391 (2017) and \$6,806 (2016)	6,247	6,704
Loans	1,093,514	871,525
Less: allowance for credit losses	(9,781)	(8,726)
Loans, net	1,083,733	862,799
Premises and equipment, net	23,054	16,558
Goodwill	27,618	11,931
Other intangible assets, net	4,719	1,079
Other real estate owned, net	1,794	2,477
Other assets	17,920	18,883
TOTAL ASSETS	\$1,393,860	\$1,160,271
LIABILITIES		
Deposits:		
Noninterest-bearing	\$328,322	\$261,575
Interest-bearing	874,459	735,914
Total deposits	1,202,781	997,489
Short-term borrowings	21,734	3,203
Other liabilities	5,609	5,280
TOTAL LIABILITIES	1,230,124	1,005,972
STOCKHOLDERS' EQUITY		
Common stock, par value \$.01 per share; shares authorized - 35,000,000; shares issued and outstanding - 12,688,224 (2017) and 12,664,797 (2016)	127	127
Additional paid in capital	65,256	64,201
Retained earnings	99,662	90,964
Accumulated other comprehensive loss	(1,309)	(993)
TOTAL STOCKHOLDERS' EQUITY	163,736	154,299
TOTAL LIABILITIES AND STOCKHOLDERS'S EQUITY	\$1,393,860	\$1,160,271

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

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,

	2017	2016	2015
INTEREST INCOME			
Interest and fees on loans	\$43,617	\$37,155	\$35,126
Interest and dividends on investment securities:			
Taxable	3,847	3,195	3,602
Tax-exempt	3	7	10
Interest on federal funds sold	-	6	3
Interest on deposits with other banks	334	289	130
Total interest income	47,801	40,652	38,871
INTEREST EXPENSE			
Interest on deposits	2,242	2,389	3,331
Interest on short-term borrowings	31	14	15
Total interest expense	2,273	2,403	3,346
NET INTEREST INCOME			
Provision for credit losses	45,528	38,249	35,525
	2,291	1,848	2,075
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES			
	43,237	36,401	33,450
NONINTEREST INCOME			
Service charges on deposit accounts	3,628	3,465	2,867
Trust and investment fee income	1,532	1,442	1,627
Gains on sales and calls of investment securities	5	30	-
Gain on sale of credit card portfolio	-	198	-
Insurance agency commissions	8,837	8,551	8,274
Other noninterest income	3,748	2,959	2,648
Total noninterest income	17,750	16,645	15,416
NONINTEREST EXPENSE			
Salaries and wages	20,011	17,626	17,540
Employee benefits	4,645	3,993	3,905
Occupancy expense	2,696	2,452	2,420
Furniture and equipment expense	1,035	963	926
Data processing	3,680	3,496	3,260
Directors' fees	380	511	470
Amortization of other intangible assets	314	131	133
FDIC insurance premium expense	599	696	1,214

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Other real estate owned expenses, net	272	505	291
Legal and professional fees	2,308	1,875	2,380
Other noninterest expenses	5,262	4,899	4,811
Total noninterest expense	41,202	37,147	37,350
INCOME BEFORE INCOME TAXES	19,785	15,899	11,516
Income tax expense	8,523	6,261	4,408
NET INCOME	\$11,262	\$9,638	\$7,108
Basic net income per common share	\$0.89	\$0.76	\$0.56
Diluted net income per common share	0.89	0.76	0.56
Dividends paid per common share	0.22	0.14	0.04

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

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31,

(Dollars in thousands)	2017	2016	2015
Net income	\$11,262	\$9,638	\$7,108
Other comprehensive (loss)			
Securities available for sale:			
Unrealized holding (losses) on available-for-sale-securities	(150)	(1,543)	(725)
Tax effect	45	622	293
Reclassification of gains recognized in net income	(5)	(30)	-
Tax effect	2	12	-
Amortization of unrealized loss on securities transferred from available-for-sale to held-to-maturity securities	30	29	76
Tax effect	(12)	(12)	(31)
Net of tax amount	(90)	(922)	(387)
Total other comprehensive (loss)	(90)	(922)	(387)
Comprehensive income	\$11,172	\$8,716	\$6,721

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

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Years Ended December 31, 2017, 2016, and 2015

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income(Loss)	Total Stockholders' Equity
Balances, January 1, 2015	\$ 126	\$ 63,532	\$ 76,495	\$ 316	\$ 140,469
Net income	-	-	7,108	-	7,108
Other comprehensive loss	-	-	-	(387)	(387)
Stock-based compensation	-	283	-	-	283
Cash dividends declared	-	-	(506)	-	(506)
Balances, December 31, 2015	126	63,815	83,097	(71)	146,967
Net income	-	-	9,638	-	9,638
Other comprehensive loss	-	-	-	(922)	(922)
Common shares issued for employee stock-based awards	-	53	-	-	53
Stock-based compensation	1	333	-	-	334
Cash dividends declared	-	-	(1,771)	-	(1,771)
Balances, December 31, 2016	127	64,201	90,964	(993)	154,299
Net income	-	-	11,262	-	11,262
Other comprehensive loss	-	-	-	(90)	(90)
Reclass of stranded tax effects from change in tax rate	-	-	226	(226)	-
Stock-based compensation	-	1,055	-	-	1,055
Cash dividends declared	-	-	(2,790)	-	(2,790)
Balances, December 31, 2017	\$ 127	\$ 65,256	\$ 99,662	\$ (1,309)	\$ 163,736

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

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,

(Dollars in thousands)	2017	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net Income	\$11,262	\$9,638	\$7,108
Adjustments to reconcile net income to net cash provided by operating activities:			
Net accretion of acquisition accounting estimates	(506)	-	-
Provision for credit losses	2,291	1,848	2,075
Depreciation and amortization	1,649	2,449	2,434
Net amortization of securities	820	(22)	(99)
Stock-based compensation expense	1,055	334	283
Deferred income tax expense	4,476	5,717	3,874
(Gains) on sales and calls of securities	(5)	(30)	-
Losses on disposals of premises and equipment	22	-	18
Losses on sales and valuation adjustments on other real estate owned	207	363	171
(Gain) on sale of credit card portfolio	-	(198)	-
Net changes in:			
Accrued interest receivable	(827)	(218)	205
Other assets	(3,330)	(98)	(870)
Accrued interest payables	(9)	(32)	(66)
Other liabilities	331	(729)	(15)
Net cash provided by operating activities	17,436	19,022	15,118
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from maturities and principal payments of investment securities available for sale	46,484	59,989	68,395
Proceeds from sales and calls of investment securities available for sale	4,000	3,961	-
Purchases of investment securities available for sale	(84,499)	(18,120)	(46,102)
Proceeds from maturities and principal payments of investment securities held to maturity	479	376	432
Purchases of securities held to maturity	-	(3,000)	-
Proceeds from the sale of credit card portfolio	-	1,428	-
Net change in loans	(100,038)	(81,369)	(88,595)
Proceeds from sale of loans	-	-	-
Purchases of premises and equipment	(1,259)	(699)	(1,518)
Proceeds from sales of premises and equipment	-	-	-
Proceeds from sales of other real estate owned	571	3,700	2,040
Cash received in branch acquisition (net of cash paid)	64,045	-	-
Net cash used in investing activities	(70,217)	(33,734)	(65,348)

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the Years Ended December 31,

CASH FLOWS FROM FINANCING ACTIVITIES:

Net changes in:

Noninterest-bearing deposits	32,185	31,890	35,872
Interest-bearing deposits	(39,263)	(9,864)	(9,412)
Short-term borrowings	18,531	(3,469)	1,864
Proceeds from the issuance of common stock	-	53	-
Common stock dividends paid	(2,790)	(1,771)	(506)
Net cash provided by financing activities	8,663	16,839	27,818
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(44,118)	2,127	(22,412)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	75,938	73,811	96,223
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$31,820	\$75,938	\$73,811

Supplemental cash flows information:

Interest paid	\$2,368	\$2,434	\$3,413
Income taxes paid	\$3,900	\$435	\$518
Transfers from loans to other real estate owned	\$95	\$2,289	\$2,773
Unrealized gain (loss) on securities available for sale	\$(155)	\$(1,664)	\$119
Amortization of unrealized loss on securities transferred from available for sale to held to maturity	\$30	\$29	\$76

Branch purchase:

Tangible assets acquired (net of cash received)	\$129,188	\$-	\$-
Identifiable intangible assets acquired	\$3,954	\$-	\$-
Liabilities assumed	\$212,463	\$-	\$-

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

SHORE BANCSHARES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended December 31, 2017, 2016, and 2015

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries (collectively referred to in these Notes as the “Company”), with all significant intercompany transactions eliminated. The investments in subsidiaries are recorded on the Company’s books (Parent only) on the basis of its equity in the net assets of the subsidiaries. The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America (“GAAP”). For purposes of comparability, certain reclassifications have been made to amounts previously reported to conform with the current period presentation.

Effective July 1, 2016, the Company’s two bank subsidiaries, The Talbot Bank of Easton Maryland and CNB were consolidated into one bank known as Shore United Bank. In these notes to the consolidated financial statements, the term “the Bank” refers to Shore United Bank, unless the context requires stipulating results of the individual banks before the consolidation occurred.

Nature of Operations

The Company engages in the banking business through Shore United Bank, a Maryland commercial bank with trust powers. The Company’s primary source of revenue is interest earned on commercial, real estate and consumer loans made to customers located in Maryland, Delaware and the Eastern Shore of Virginia. The Company engages in the insurance business through an insurance producer firm, The Avon-Dixon Agency, LLC, (“Avon-Dixon”) with two specialty lines, Elliott Wilson Insurance (Trucking) and Jack Martin Associates (Marine); and an insurance premium finance company, Mubell Finance, LLC (“Mubell”) (Avon-Dixon and Mubell are collectively referred to as the “Insurance Subsidiaries”). Avon-Dixon and Mubell are wholly-owned subsidiaries of Shore Bancshares, Inc. The Company engages in the trust services business through the trust department at Shore United Bank under the trade name Wye Financial & Trust.

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting

period. Actual results could differ from those estimates. Estimates that could change significantly relate to the determination of the allowance for loan losses, the determination of fair values related to impaired loans and other real estate owned, fair values initially assigned in an acquisition and subsequent evaluations of the related goodwill and intangible assets for impairment, and the valuation of deferred tax assets.

Investment Securities Available for Sale

Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent those securities which management may sell as part of its asset/liability management strategy or which may be sold in response to changing interest rates, changes in prepayment risk or other similar factors. Realized gains and losses are recorded in noninterest income and are determined on a trade date basis using the specific identification method. Premiums and discounts are amortized or accreted into interest income using the interest method over the expected lives of the individual securities. Interest and dividends on investment securities are recognized in interest income on an accrual basis. Net unrealized holding gains and losses on these securities are reported as accumulated other comprehensive income, a separate component of stockholders' equity, net of related income taxes. Declines in the fair value of individual available-for-sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value and are reflected in earnings as realized losses. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

Investment Securities Held to Maturity

Investment securities held to maturity are stated at cost adjusted for amortization of premiums and accretion of discounts. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. The Company intends and has the ability to hold such securities until maturity. Declines in the fair value of individual held-to-maturity securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Factors affecting the determination of whether an other-than-temporary impairment has occurred include a downgrade of the security by a rating agency, a significant deterioration in the financial condition of the issuer, or a determination that management has the intent to sell the security or will be required to sell the security before recovery of its amortized cost.

Loans

Loans are stated at their principal amount outstanding net of any deferred fees, premiums, discounts and costs and net of any partial charge-offs. Interest income on loans is accrued at the contractual rate based on the principal amount outstanding. Fees charged and costs capitalized for originating loans are being amortized substantially on the interest method over the term of the loan. A loan is placed on nonaccrual (i.e., interest income is no longer accrued) when it is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more, unless the loan is well secured and in the process of collection. Any unpaid interest previously accrued on those loans is reversed from income. Interest payments received on nonaccrual loans are applied as a reduction of the loan principal balance unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired if it is probable that the Company will not collect all principal and interest payments according to the loan's contractual terms. An impaired loan may show deficiencies in the borrower's overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Generally, the Company measures impairment on such loans by reference to the fair value of the collateral. Once the amount of impairment has been determined, the uncollectible portion is charged off. Income on impaired loans is recognized on a cash basis, and payments are first applied against the principal balance outstanding (i.e., placing impaired loans on nonaccrual status). Generally, interest income is not recognized on impaired loans unless the likelihood of further loss is remote. The allowance for credit losses may include specific reserves related to impaired loans. Specific reserves remain until charge offs are made. Impaired loans do not include groups of smaller balance homogeneous loans such as residential mortgage and consumer installment loans that are evaluated collectively for impairment. Reserves for probable credit losses related to these loans are based on historical loss ratios and an analysis of qualitative factors and are included in the formula portion of the allowance for credit losses. See additional discussion below under the section, "Allowance for Credit Losses".

A loan is considered a troubled debt restructuring ("TDR") if a borrower is experiencing financial difficulties and a creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. Loans are identified to be restructured when signs of impairment arise such as borrower interest rate reduction request, slowness to pay, or when an inability to repay becomes evident. The terms being offered are evaluated to determine if they are more liberal than those that would be indicated by policy or industry standards for similar, untroubled credits. In those situations where the terms or the interest rates are considered to be more favorable than industry standards or the current underwriting guidelines of the Company's banking subsidiary, the loan is classified as a TDR. All loans designated as TDRs are considered impaired loans and may be on either accrual or nonaccrual status. In instances where the loan has been placed on nonaccrual status, six consecutive months of timely payments are required prior to returning the loan to accrual status.

All loans classified as TDRs which are restructured and accrue interest under revised terms require a full and comprehensive review of the borrower's financial condition, capacity for repayment, realistic assessment of collateral values, and the assessment of risk entered into any workout agreement. Current financial information on the borrower, guarantor, and underlying collateral is analyzed to determine if it supports the ultimate collection of principal and interest. For commercial loans, the cash flows are analyzed, both for the underlying project and globally. For consumer loans, updated salary, credit history and cash flow information is obtained. Current market conditions are also considered. Following a full analysis, the determination of the appropriate loan structure is made. The Company does not participate in any specific government or Company sponsored loan modification programs. All TDR loan agreements are contracts negotiated with each of the borrowers.

Allowance for Credit Losses

The allowance for credit losses is maintained at a level believed adequate by management to absorb losses inherent in the loan portfolio as of the balance sheet date and is based on the size and current risk characteristics of the loan portfolio, an assessment of individual problem loans and actual loss experience, current economic events in specific industries and geographical areas, including unemployment levels, and other pertinent factors, including regulatory guidance and general economic conditions and other observable data. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or collateral value of impaired loans, estimated losses on pools of homogeneous loans that are based on historical loss experience, and consideration of current economic trends, all of which may be susceptible to significant change. Loans, or portions thereof, that are considered uncollectible are charged off against the allowance, while recoveries of amounts previously charged off are credited to the allowance. The criteria for charge offs are addressed in the Bank's Collection and Workout Policy. Per the policy, the recognition of the loss of loans or portions of loans will occur when there is a reasonable probability of loss. When the amount of loss can be readily calculated, the loss will be recognized. In cases where a probable charge-off amount cannot be calculated, specific reserves will be maintained. A provision for credit losses is charged to income based on management's periodic evaluation of the factors previously mentioned, as well as other pertinent factors. Evaluations are conducted at least quarterly and more often if deemed necessary.

The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: (i) Topic 450, “*Contingencies*”, of the Financial Accounting Standards Board’s Accounting Standards Codification (“ASC”), which requires that losses be accrued when they are probable of occurring and estimable; and (ii) ASC Topic 310, “*Receivables*”, which requires that losses be accrued based on the differences between the loan balance and the value of collateral, present value of future cash flows or values that are observable in the secondary market. Management uses many factors to estimate the inherent loss that may be present in our loan portfolio, including economic conditions and trends, the value and adequacy of collateral, the volume and mix of the loan portfolio, and our internal loan processes. Actual losses could differ significantly from management’s estimates. In addition, GAAP itself may change from one previously acceptable method to another. Although the economics of transactions would be the same, the timing of events that would impact the transactions could change.

Three basic components comprise our allowance for credit losses: (i) the specific allowance; (ii) the historical formula allowance; and (iii) the qualitative formula allowance. Each component is determined based on estimates that can and do change when the actual events occur. The specific allowance is established against impaired loans (i.e., nonaccrual loans and troubled debt restructurings (“TDRs”)) based on our assessment of the losses that may be associated with the individual loans. The specific allowance remains until charge-offs are made. An impaired loan may show deficiencies in the borrower’s overall financial condition, payment history, support available from financial guarantors and/or the fair market value of collateral

The historical formula allowance is used to estimate the loss on internally risk-rated loans, exclusive of those identified as impaired. Loans are grouped by type (construction, residential real estate, commercial real estate, commercial or consumer). Each loan type is assigned allowance factors based on management’s estimate of the risk, complexity and size of individual loans within a particular category using average historical charge-offs by segment over the last 16 quarters. Loans identified as pass-watch, special mention, substandard, and doubtful are considered to have elevated credit risk. These loans are assigned higher allowance factors than favorably rated loans due to management’s concerns regarding collectability or management’s knowledge of particular elements regarding the borrower. The qualitative formula allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or historical formula allowance. A pass-watch loan has adequate risk and may include loans which may have been upgraded from another higher risk category. A special mention loan has potential weaknesses that could result in a future loss to the Company if the weaknesses are realized. A substandard loan has certain deficiencies that could result in a future loss to the Company if these deficiencies are not corrected. A doubtful loan has enough risk that there is a high probability that the Company will sustain a loss.

Management has significant discretion in making the adjustments inherent in the determination of the provision and allowance for credit losses, including in connection with the valuation of collateral, the estimation of a borrower’s prospects of repayment, and the establishment of the allowance factors in the formula allowance and unallocated allowance components of the allowance. The establishment of allowance factors is a continuing exercise, based on management’s ongoing assessment of the totality of all factors, including, but not limited to, delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, the quality of the loan review system and the effect of external factors such as competition and regulatory requirements, and their impact on the portfolio.

Allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based on the same volume and classification of loans. Changes in allowance factors will have a direct impact on the amount of the provision, and a corresponding effect on net income. Errors in management's perception and assessment of these factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs.

Premises and Equipment

Land is carried at cost and premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated using the straight-line method over the estimated useful lives of the assets. Useful lives range from three to 10 years for furniture, fixtures and equipment; three to five years for computer hardware and data handling equipment; and 10 to 40 years for buildings and building improvements. Land improvements are amortized over a period of 15 years and leasehold improvements are amortized over the term of the respective lease. Sale-leaseback transactions are considered normal leasebacks and any realized gains are deferred and amortized to other income on a straight-line basis over the initial lease term. Maintenance and repairs are charged to expense as incurred, while improvements which extend the useful life of an asset are capitalized and depreciated over the estimated remaining life of the asset.

Long-lived assets are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Company recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset.

Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill and other intangible assets are initially required to be recorded at fair value. Determining fair value is subjective, requiring the use of estimates, assumptions and management judgment. Goodwill and other intangible assets with indefinite lives are tested at least annually for impairment, usually during the third quarter, or on an interim basis if circumstances dictate. Intangible assets that have finite lives are amortized over their estimated useful lives and also are subject to impairment testing.

Impairment testing requires that the fair value of each of the Company's reporting units be compared to the carrying amount of its net assets, including goodwill. The Company's reporting units were identified based on an analysis of each of its individual operating segments (i.e., the Bank and Insurance Subsidiaries). If the fair value of a reporting unit is less than book value, an expense may be required to write down the related goodwill or purchased intangibles to record an impairment loss.

During the third quarter of 2017 and 2016, goodwill and other intangible assets were subjected to the annual assessment for impairment. As a result of the assessment, it was determined that it was not more likely than not that the fair values of the Company's reporting units were less than their carrying amounts so no impairment was recorded.

Other Real Estate Owned

Other real estate owned represents assets acquired in satisfaction of loans either by foreclosure or deeds taken in lieu of foreclosure. Properties acquired are recorded at fair value less estimated selling costs at the time of acquisition, establishing a new cost basis. Thereafter, costs incurred to operate or carry the properties as well as reductions in value as determined by periodic appraisals are charged to operating expense. Gains and losses resulting from the final disposition of the properties are included in noninterest income.

Short-Term Borrowings

Short-term borrowings are comprised primarily of repurchase agreements. The repurchase agreements are securities sold to the Company's customers, at the customers' request, under a continuing "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated from the Company's other investment securities by its safekeeping agents.

Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return. The Company accounts for income taxes using the liability method in accordance with required accounting guidance. Under this method, deferred tax assets and liabilities are determined by applying the applicable federal and state income tax rates to cumulative temporary differences. These temporary differences represent differences between financial statement carrying amounts and the corresponding tax bases of certain assets and liabilities. Deferred taxes result from such temporary differences.

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. 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 the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

The Company recognizes accrued interest and penalties as a component of tax expense. Significant judgement is required in evaluating the Company's uncertain tax positions, determining its provision for income taxes and evaluating the impact of the Tax Act.

The U.S. Tax Cuts and Jobs Act ("Tax Act") was enacted on December 22, 2017 and introduces significant changes to U.S. income tax law. Effective in 2018, the Tax Act reduces the U.S. statutory tax rate from 35% to 21% and creates new taxes on certain foreign-sourced earnings and certain related-party payments, which are referred to as the global intangible low-taxes income tax and base erosion tax, respectively. In addition, in 2017 the Company is subject to a one-time transition tax on accumulated foreign subsidiary earnings not previously subject to U.S. income tax. Accounting for the income tax effects of the Tax Act requires significant judgements and estimates in the interpretation and calculations of the provisions of the Tax Act.

Due to the timing of the enactment and the complexity involved in applying the provisions of the Tax Act, the Company has made reasonable estimates of the effects and recorded provisional amounts in its financial statements for the year ended December 31, 2017. As the Company collects and prepares the necessary data, and interprets additional guidance issued by the U.S. Treasury Department, the IRS or other standard-setting bodies, it may make adjustments to the provisional amounts. Those adjustments may materially impact the provision for income taxes and the effective tax rate in the period in which the adjustments are made. The accounting for the tax effects of the enactment of the Tax Act will be completed in 2018.

Although the Company believes it has adequately reserved for its uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. The Company adjusts these reserves in light of changing facts and circumstances, such as the closing of a tax audit or the refinement of an estimate. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes and the effective tax rate in the period in which such determination is made.

The provision for income taxes includes the impact of reserve provisions and changes in the reserves that are considered appropriate as well as the related net interest and penalties. In addition, the Company is subject to the continuous examination of its income tax returns by the IRS and other tax authorities which may assert assessments against the Company. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations and assessments to determine the adequacy of its provision for income taxes. The Company remains subject to examination for tax years ending on or after December 31, 2014.

Basic and Diluted Earnings Per Common Share

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Included in this calculation due to dividend participation rights are restricted stock awards which have been granted. Diluted earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding, adjusted for the effect of any potentially dilutive common stock equivalents.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (i) the assets have been isolated from the Company, (ii) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (iii) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Cash and Cash Equivalents

Cash and due from banks, interest-bearing deposits with other banks and federal funds sold are considered “cash and cash equivalents” for financial reporting purposes. Interest-bearing deposits with banks generally exceed balances that are recoverable under Federal Deposit Insurance Corporation (“FDIC”) insurance.

Share-Based Compensation

The Company may grant share-based compensation to employees and non-employee directors in the form of restricted stock, restricted stock units and stock options. The fair value of restricted stock is determined based on the closing price of the Parent’s common stock on the date of grant. The Company recognizes compensation expense related to restricted stock on a straight-line basis over the vesting period for service-based awards, plus additional recognition of costs associated with accelerated vesting based on the projected attainment of Company performance measures. Restricted stock units (“RSUs”) are payable solely in cash which are accounted for as other liabilities in the consolidated statements of condition. The fair value of RSUs is initially valued based on the closing price of the Parent’s common stock on the date of grant and is amortized in the statement of income over the vesting period. The RSUs are

subsequently remeasured in the same manner described above at the end of each reporting period until settlement. The fair value of stock options is estimated at the date of grant using the Black-Scholes option pricing model and related assumptions. The Company uses historical data to predict option exercise and employee termination behavior. Expected volatilities are based on the historical volatility of the Parent's common stock. The expected term of options granted is derived from actual historical exercise activity and represents the period of time that options granted are expected to be outstanding. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant based on the expected life of the option. The dividend yield is equal to the dividend yield of the Parent's common stock at the time of grant. The amortization of the expense related to stock options reflects estimated forfeitures, adjusted for actual forfeiture experience. Amortization expense related to stock options is recorded in the statements of income as a component of salaries and benefits for employees and as a component of other noninterest expense for non-employee directors, with a corresponding increase to capital surplus in shareholders' equity. As the expense related to stock options is recognized, a deferred tax asset is established that represents an estimate of future income tax deductions from the release of restrictions or the exercise of stock options. See Note 13 for a further discussion.

Fair Value

The Company measures certain financial assets and liabilities at fair value, with the measurements made on a recurring or nonrecurring basis. Significant financial instruments measured at fair value on a recurring basis are investment securities available for sale. Impaired loans and other real estate owned are significant financial instruments measured at fair value on a nonrecurring basis. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company is required to maximize the use of observable inputs and minimize the use of unobservable inputs, reducing subjectivity. See Note 21 for a further discussion of fair value.

Advertising Costs

Advertising costs are generally expensed as incurred. The Company incurred advertising costs of approximately \$662 thousand, \$528 thousand and \$495 thousand for the years ended December 31, 2017, 2016, and 2015, respectively.

Comprehensive Income

Changes in unrealized gains and losses on available-for-sale securities is the only component of accumulated other comprehensive income for the Company. The amount reclassified out of other accumulated comprehensive income relating to a gain on call of available-for-sale securities was \$5 thousand and \$30 thousand for 2017 and 2016, respectively. The related tax effect for the reclassification was \$2 thousand and \$12 thousand for 2017 and 2016, respectively.

In February 2018, the FASB issued ASU 2018-02, “*Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (“AOCI”)*”. The Company early adopted this new standard in the current year. ASU 2018-01 requires reclassification from AOCI to retained earnings for stranded tax effects resulting from the impact of newly enacted federal corporate income tax rate on items included in AOCI. The amount of this reclassification in 2017 was \$226 thousand.

Recent Accounting Standards

ASU No. 2014-09, “*Revenue from Contracts with Customers (Topic 606)*” amendment requires entities to recognize revenue to depict the transfer of promised goods or services to customers in amounts that reflect the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 is effective for periods beginning after December 15, 2016. ASU 2015-14, “*Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date*” – ASU 2015-14 amendments defer the effective date of Update 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. ASU 2016-08, “*Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations*” – ASU 2016-08 amendments are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. ASU 2016-10, “*Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*” – ASU 2016-10 amendments clarify that contractual provisions that, explicitly or implicitly, require an entity to transfer control of additional goods or services to a customer should be distinguished from contractual provisions that, explicitly or implicitly, define the attributes of a single promised license. Attributes of a promised license define the scope of a customer’s right to use or right to access an entity’s intellectual property and, therefore, do not define whether the entity satisfies its performance obligation at a point in time or over time and do not create an obligation for the entity to transfer any additional rights to use or access its intellectual property. Revenues from services provided by financial institutions that could be impacted by the new guidance includes credit card arrangements, trust and custody services and administration services for customer deposits accounts (e.g., ATM and wire transfer transactions). This update will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Adoption of the ASU is not expected to have a significant impact on the Company’s consolidated financial statements and related disclosures. The Company’s primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company’s revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains/losses on the sale of OREO, is not expected to change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company is currently planning to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption. Periods prior to the date of adoption are not retrospectively revised, but a cumulative effect of adoption is recognized for the impact of the ASU on uncompleted contracts at the date of adoption.

ASU No. 2016-01, “*Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*”. This ASU, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the

impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-01 will be effective for us on January 1, 2018 and is not expected to have a significant impact on our financial statements. The Company is currently evaluating methods of measuring fair value of its loan portfolio using an exit price notion as noted in (iv) above. In addition, the Company has hired a third-party valuation expert to aid in the transition to the fair value guidance.

ASU No. 2016-02, "*Leases (Topic 842)*." This ASU stipulates that a lessee should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statement*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous GAAP, which did not require lease assets and lease liabilities to be recognized for most leases. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option. In addition, also consistent with the previous leases guidance, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The amendments in this ASU are effective for fiscal years after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Leases and lessors may not apply a full retrospective transition approach. While the Company is currently evaluating the impact of the new standard, we expect an increase to the Consolidated Balance Sheets for right-of-use assets and interest expense of the lease liabilities in the Consolidated Statements of Income, for arrangements previously accounted for as operating leases. Therefore, the Company's preliminary evaluation indicates the provisions of ASU No. 2016-02 are expected to impact the Company's consolidated statements of condition, along with our regulatory capital ratios. However, the Company continues to evaluate the extent of potential impact the new guidance will have on the Company's Consolidated Financial Statements. The Company is in the process of developing an inventory of all leases and accumulating the lease data necessary to apply the amended guidance.

ASU No. 2016-09, "*Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.*" This ASU simplifies the treatment and accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public business entities, the amendments in this update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Early adoption is permitted for any entity in any interim or annual period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. Upon adoption of ASU No. 2016-09 on January 1, 2017, the Company made an accounting policy election to recognize forfeitures of stock-based awards as they occur. The adoption of ASU No. 2016-09 did not have a material impact on our consolidated financial statements.

ASU No. 2016-13, "*Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.*" The amendments in this ASU will replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash. The amendments broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The use of forecasted information incorporates more timely information in the estimate of expected credit losses, which will be more decision useful to users of the financial statements. It is not expected that an entity will need to create an economic forecast over the entire contractual life of long-dated financial assets. Therefore, the amendments will allow an entity to revert to historical loss information that is reflective of the contractual term (considering the effect of prepayments) for periods that are beyond the time frame for which the entity is able to develop reasonable and supportable forecasts. The amendments retain many of the disclosure amendments in Accounting Standards Update No. 2010-20, Receivables (Topic 310): *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, updated to reflect the change from an incurred loss methodology to an expected credit loss methodology. Credit losses on available-for-sale debt securities should be measured in a manner similar to current GAAP. However, the amendments require that credit losses be presented as an allowance rather than a write-down. For public entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All entities may adopt the amendments earlier as of the fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company believes this ASU will have a significant impact on our consolidated financial statements and the method in which we calculate our credit losses, primarily on loans and held to maturity securities. At this time, the Company has established a project management team which is in the process of developing and understanding this pronouncement, evaluating the impact of this pronouncement and researching additional software resources that could assist with the implementation.

ASU No. 2016-15, "*Classification of Certain Cash Receipts and Cash Payments.*" Current GAAP is unclear or does not include specific guidance on how to classify certain transactions in the statement of cash flows. This ASU is intended to reduce diversity in practice in how eight particular transactions are classified in the statement of cash flows. ASU No. 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted, provided that all of the amendments are adopted in the same period. Entities will be

required to apply the guidance retrospectively. If it is impracticable to apply the guidance retrospectively for an issue, the amendments related to that issue would be applied prospectively. We adopted the amendments in this ASU effective January 1, 2017. The adoption of ASU No. 2016-15 did not have a material impact on our consolidated financial statements.

ASU No. 2017-01 – In January 2017, FASB issued ASU No. 2017-01, *Business Combinations (Topic 805) Clarifying the Definition of a Business*. The ASU clarifies the definition of a business to assist with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The guidance is not expected to have a significant impact on the Company’s financial positions, results of operations or disclosures.

ASU No. 2017-03 – In January 2017, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2017-03, *Accounting Changes and Error Corrections (Topic 250) and Investments – Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings*.” The ASU adds an SEC paragraph to ASUs 2014-09, 2016-02, and 2016-13 which specifies the SEC staff view that a registrant should evaluate ASUs that have not yet been adopted to determine the appropriate disclosure about the potential material effects of those ASUs on the financial statements when adopted. The guidance also specifies the SEC staff view on financial statement disclosures when the company does not know or cannot reasonably estimate the impact that adoption of the ASUs will have on the financial statements. The ASU also conforms SEC guidance on accounting for tax benefits resulting from investments in affordable housing projects to the guidance in ASU 2014-01, *Investments – Equity Method and Joint Ventures (Topic 323)*. The amendments in this update are effective upon issuance. The guidance did not have a significant impact on our consolidated financial statements.

ASU No. 2017-04 – In January 2017, FASB issued ASU No. 2017-04, “*Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.*” The ASU simplifies measurement of goodwill and eliminates Step 2 from the goodwill impairment test. The Company should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value. The impairment charge is limited to the amount of goodwill allocated to that reporting unit. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The guidance is not expected to have a significant impact on the Company’s financial positions, results of operations or disclosures.

ASU No. 2017-08 – In March 2017, the FASB issued ASU No. 2017-08, “*Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.*” Under current GAAP, entities normally amortize the premium as an adjustment of yield over the contractual life of the instrument. This guidance shortens the amortization period of certain callable debt securities held at a premium to the earliest call date. This update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The adoption of ASU No. 2017-08 is not expected to have a material impact on the Company’s consolidated financial statements.

ASU No. 2017-09 – In May 2017, the FASB issued ASU No. 2017-09 “*Stock Compensation, Scope of Modification Accounting.*” This ASU clarifies when changes to the terms of conditions of a share-based payment award must be accounted for as modifications. Companies will apply the modification accounting guidance if the value, vesting conditions or classification of the award changes. The new guidance should reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications, as the guidance will allow companies to make certain non-substantive changes to awards without accounting for them as modifications. It does not change the accounting for modifications. ASU No. 2017-09 is effective for interim and annual reporting periods beginning after December 15, 2017; early adoption is permitted. ASU No. 2017-09 is not expected to have a material impact on the Company’s consolidated financial statements.

ASU 2018-02 – In February 2018, the FASB issued ASU No. 2018-02 “*Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.*” The amendments provide financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company has elected to reclassify the stranded income tax effects from the Tax Cuts and Jobs Act in the financial statements for the period ending December 31, 2017. The amount of this reclassification in 2017 was \$226 thousand.

NOTE 2. BUSINESS COMBINATION

Northwest Bank Branch Acquisition

On May 19, 2017, the Bank purchased three branches from Northwest Bank (“NWBI”) located in Arbutus, Elkridge, and Owings Mills, Maryland. Pursuant to the transaction, the Bank acquired \$122.9 million in loans and \$212.5 million in deposits, as well as the branch premises and equipment. In connection with its purchase of the branches from NWBI, the Bank received a cash payment from NWBI of \$64.0 million, which was net of a premium paid on deposits of \$17.2 million. In addition to the premium paid on deposits, other costs associated with the acquisition totaled \$977 thousand. This acquisition provides the Bank with the opportunity to enhance its footprint in Maryland by extending its branch network across the Eastern Shore to the greater Baltimore area communities of Elkridge, Owings Mills and Arbutus.

The Company has accounted for the branch purchases under the acquisition method of accounting in accordance with FASB ASC topic 805, “Business Combinations,” whereby the acquired assets and liabilities were recorded by the Bank at their estimated fair values as of their acquisition date.

The acquired assets and assumed liabilities of the NWBI branches were measured at estimated fair value. Management made significant estimates and exercised significant judgement in accounting for the acquisition of the NWBI branches. Management evaluated expected cash flows, prepayment speeds and estimated loss factors to measure fair values for loans. Deposits were valued based upon interest rates, original and remaining terms and maturities, as well as current rates for similar funds in the same markets. Premises were based on recent appraised values, whereas equipment was acquired based on the remaining book value from NWBI, which approximated fair value. Management engaged independent outside experts to provide the fair value estimates. Subsequent to the purchase, Management made a measurement period adjustment for deferred taxes related to intangible assets of \$291 thousand.

The following table provides the purchase price as of the acquisition date, the identifiable assets acquired and liabilities assumed at their estimated fair values, and the resulting goodwill of \$15.0 million recorded from the acquisition:

Purchase Price Consideration:	
Cash consideration	\$ 17,186
Total purchase price for NWBI branch acquisition	\$ 17,186
Assets acquired at fair value:	
Cash and cash equivalents	\$ 81,231
Loans	122,862
Premises and equipment, net	6,326
Core deposit intangible	3,954
Deferred tax assets	291
Total fair value of assets acquired	\$ 214,664
Liabilities assumed at fair value:	
Deposits	\$ 212,456
Other liabilities	7
Total fair value of liabilities assumed	\$ 212,463
Net assets acquired at fair value:	\$ 2,201
Amount of goodwill resulting from acquisition	\$ 14,985

The total amount of goodwill arising from this transaction of \$15.0 million is expected to be deductible for tax purposes, pursuant to section 197 of the Internal Revenue Code.

Acquired loans

The following table outlines the contractually required payments receivable, cash flows we expect to receive, and the accretable yield for all NWBI loans as of the acquisition date.

Contractually Required Payments Receivable	Cash Flows Expected To Be Collected	Accretable FMV Adjustments	Carrying Value of Loans Receivable
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Performing loans acquired	\$ 125,131	125,131	2,269	\$ 122,862
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The Company recorded all loans acquired at the estimated fair value on the purchase date with no carryover of the related allowance for loan losses. The Company only acquired loans which were deemed to be performing loans with no signs of credit deterioration.

The Company determined the net discounted value of cash flows on approximately 864 performing loans totaling \$125.1 million. The valuation took into consideration the loans' underlying characteristics, including account types, remaining terms, annual interest rates, interest types, past delinquencies, timing of principal and interest payments, current market rates, loan-to-value ratios, loss exposures, and remaining balances. These performing loans were segregated into pools based on loan and payment type. The effect of this fair valuation process was a net accretable discount adjustment of \$2.3 million at acquisition.

NOTE 3. INVESTMENT SECURITIES

The following table provides information on the amortized cost and estimated fair values of investment securities.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:				
December 31, 2017				
U.S. Government agencies	\$ 45,806	\$ 23	\$ 497	\$ 45,332
Mortgage-backed Equity	152,198 666	157 -	1,390 8	150,965 658
Total	\$ 198,670	\$ 180	\$ 1,895	\$ 196,955
December 31, 2016				
U.S. Government agencies	\$ 34,320	\$ 56	\$ 58	\$ 34,318
Mortgage-backed Equity	130,490 652	263 -	1,809 12	128,944 640
Total	\$ 165,462	\$ 319	\$ 1,879	\$ 163,902
Held-to-maturity securities:				
December 31, 2017				
U.S. Government agencies	\$ 1,844	\$ 21	\$ -	\$ 1,865
States and political subdivisions	1,403	47	-	1,450
Other Debt Securities (1)	3,000	76	-	3,076
Total	\$ 6,247	\$ 144	\$ -	\$ 6,391
December 31, 2016				
U.S. Government agencies	\$ 2,089	\$ 26	\$ -	\$ 2,115
States and political subdivisions	1,615	76	-	1,691
Other Debt Securities (1)	3,000	-	-	3,000
Total	\$ 6,704	\$ 102	\$ -	\$ 6,806

(1) On December 15, 2016 the Company bought \$3.0 million in subordinated notes from a local regional bank which it intends to hold to maturity of December 30, 2026.

The following table provides information about gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position at December 31, 2017.

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2017						
Available-for-sale securities:						
U.S. Government agencies	\$37,550	\$ 453	\$5,956	\$ 44	\$43,506	\$ 497
Mortgage-backed	96,622	700	28,215	690	124,837	1,390
Equity securities	-	-	666	8	666	8
Total	\$134,172	\$ 1,153	\$34,837	\$ 742	\$169,009	\$ 1,895

(Dollars in thousands)	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2016						
Available-for-sale securities:						
U.S. Government agencies	\$11,926	\$ 58	\$-	\$ 104	\$11,926	\$ 162
Mortgage-backed	100,237	1,546	9,208	263	109,445	1,809
Equity securities	640	12	-	-	640	12
Total	\$112,803	\$ 1,616	\$9,208	\$ 367	\$122,011	\$ 1,983

Held-to-maturity securities:

U.S. Government agencies	\$2,115	\$ 78	\$-	\$ -	\$2,115	\$ 78
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All of the securities with unrealized losses in the portfolio have modest duration risk, low credit risk, and minimal losses when compared to total amortized cost. The unrealized losses on debt securities that exist are the result of market changes in interest rates since original purchase and are not related to credit concerns. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost bases, which may be at maturity for debt securities, the Company considers the unrealized losses to be temporary. There were seventy-two securities in an unrealized loss position at December 31, 2017.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at December 31, 2017.

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(Dollars in thousands)	Available for sale		Held to maturity	
	Amortized		Amortized	
	Cost	Fair Value	Cost	Fair Value
Due in one year or less	\$11,002	\$ 10,969	\$-	\$ -
Due after one year through five years	34,964	34,475	902	935
Due after five years through ten years	39,573	39,252	501	515
Due after ten years	112,465	111,601	4,844	4,941
	198,004	196,297	6,247	6,391
Equity securities	666	658	-	-
Total	\$198,670	\$ 196,955	\$6,247	\$ 6,391

The maturity dates for debt securities are determined using contractual maturity dates.

The following table sets forth the amortized cost and estimated fair values of securities which have been pledged as collateral for obligations to federal, state and local government agencies, and other purposes as required or permitted by law, or sold under agreements to repurchase. All pledged securities are in the available-for-sale investment portfolio.

(Dollars in thousands)	December 31, 2017		December 31, 2016	
	Amortized		Amortized	
	Cost	Fair Value	Cost	Fair Value
Pledged available-for-sale securities	\$ 131,035	\$ 129,880	\$ 140,042	\$ 138,875

There were no obligations of states or political subdivisions with carrying values, as to any issuer, exceeding 10% of stockholders' equity at December 31, 2017 or 2016.

Proceeds from sales of investment securities were \$0, \$4.0 million, and \$0 for the years ended December 31, 2017, 2016, and 2015, respectively. Gross gains from sales and calls of investment securities were \$5 thousand, \$30 thousand and \$0 for the years ended December 31, 2017, 2016, and 2015, respectively. There were no gross losses in 2017, 2016 and 2015.

NOTE 4. LOANS AND ALLOWANCE FOR CREDIT LOSSES

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Baltimore City, Baltimore County, Howard County, Kent County, Queen Anne's County, Caroline County, Talbot County and Dorchester County in Maryland, Kent County, Delaware and in Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at December 31, 2017 and 2016.

(Dollars in thousands)	2017	2016
Construction	\$ 125,746	\$ 84,002
Residential real estate	399,190	325,768
Commercial real estate	464,887	382,681
Commercial	97,284	72,435
Consumer	6,407	6,639
Total loans	1,093,514	871,525
Allowance for credit losses	(9,781)	(8,726)
Total loans, net	\$ 1,083,733	\$ 862,799

In the normal course of banking business, loans are made to officers and directors and their affiliated interests. These loans are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with persons who are not related to the Company and are not considered to involve more than the normal risk of collectibility. As of December 31, 2017 and 2016, such loans outstanding, both direct and indirect (including guarantees), to directors, their associates and policy-making officers, totaled approximately \$13.8 million and \$13.3 million, respectively. During 2017 and 2016, loan additions were approximately \$2.3 million and \$3.3 million, respectively, and loan repayments were approximately \$1.8 million and \$1.1 million, respectively. Due to the consolidation of the former Bank subsidiaries and their Board of Directors during 2016, many directors who served on those boards no longer serve as members of the new consolidated Bank as of December 31, 2016. This resulted in approximately \$10.8 million in outstanding loans being excluded for reporting loans made to inside directors of the Company and its subsidiaries as of December 31, 2016. Net loan origination costs, included in balances above, totaled \$609 thousand and \$509 thousand as of December 31, 2017 and 2016, respectively. Also included in total loans at December 31, 2017 were \$108.1 million in loans, acquired in the current year as part of the NWBI branch acquisition. These balances are presented net of the related discount which totaled \$1.8 million at December 31, 2017.

In the normal course of banking business, risks related to specific loan categories are as follows:

Construction loans – Construction loans generally finance the construction of residential real estate for builders and individuals for single family dwellings. In addition, the Bank periodically finances the construction of commercial projects. Credit risk factors include the borrower's ability to successfully complete the construction on time and within budget, changing market conditions which could affect the value and marketability of projects, changes in the borrower's ability or willingness to repay the loan and potentially rising interest rates which can impact both the borrower's ability to repay and the collateral value.

Residential real estate – Residential real estate loans are typically made to consumers and are secured by residential real estate. Credit risk arises from the borrower's continuing financial stability, which can be adversely impacted by job loss, divorce, illness, or personal bankruptcy, among other factors. Also impacting credit risk would be a shortfall in the value of the residential real estate in relation to the outstanding loan balance in the event of a default or subsequent liquidation of the real estate collateral.

Commercial real estate – Commercial real estate loans consist of both loans secured by owner occupied properties and non-owner occupied properties where an established banking relationship exists and involves investment properties for warehouse, retail, and office space with a history of occupancy and cash flow. These loans are subject to adverse changes in the local economy and commercial real estate markets. Credit risk associated with owner occupied properties arises from the borrower’s financial stability and the ability of the borrower and the business to repay the loan. Non-owner occupied properties carry the risk of a tenant’s deteriorating credit strength, lease expirations in soft markets and sustained vacancies which can adversely impact cash flow.

Commercial – Commercial loans are secured or unsecured loans for business purposes. Loans are typically secured by accounts receivable, inventory, equipment and/or other assets of the business. Credit risk arises from the successful operation of the business which may be affected by competition, rising interest rates, regulatory changes and adverse conditions in the local and regional economy.

Consumer – Consumer loans include home equity loans and lines, installment loans and personal lines of credit. Credit risk is similar to residential real estate loans above as it is subject to the borrower’s continuing financial stability and the value of the collateral securing the loan.

The following tables include impairment information relating to loans and the allowance for credit losses as of December 31, 2017 and 2016.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
December 31, 2017						
Loans individually evaluated for impairment	\$ 6,975	\$ 6,018	\$ 4,967	\$ 337	\$ -	\$ 18,297
Loans collectively evaluated for impairment	118,771	393,172	459,920	96,947	6,407	1,075,217
Total loans	\$ 125,746	\$ 399,190	\$ 464,887	\$ 97,284	\$ 6,407	\$ 1,093,514
Allowance for credit losses allocated to:						
Loans individually evaluated for impairment	\$ 500	\$ 239	\$ 33	\$ 33	\$ -	\$ 805
Loans collectively evaluated for impairment	1,960	2,045	2,561	2,208	202	8,976
Total loans	\$ 2,460	\$ 2,284	\$ 2,594	\$ 2,241	\$ 202	\$ 9,781

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
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December 31, 2016

Loans individually evaluated for impairment	\$ 8,007	\$ 7,778	\$ 6,088	\$ -	\$ 99	\$ 21,972
Loans collectively evaluated for impairment	75,995	317,990	376,593	72,435	6,540	849,553
Total loans	\$ 84,002	\$ 325,768	\$ 382,681	\$ 72,435	\$ 6,639	\$ 871,525

Allowance for credit losses allocated to:

Loans individually evaluated for impairment	\$ 1,639	\$ 317	\$ 185	\$ -	\$ -	\$ 2,141
Loans collectively evaluated for impairment	1,148	1,636	2,425	1,145	231	6,585
Total loans	\$ 2,787	\$ 1,953	\$ 2,610	\$ 1,145	\$ 231	\$ 8,726

In the fourth quarter of 2017, management made a change to its method for calculating the allowance. This change and the effect on the allowance for loan losses at December 31, 2017 was as follows:

The Company added pass/watch credits to an existing pool that included loans that are risk rated as special mention and substandard to be collectively evaluated for impairment for both quantitative and qualitative factors. The Company believes that attributing additional reserves to this pool of loans better reflects the perceived risk for the total loan portfolio going forward, due to the significant organic loan growth over the past 24 months, the increase in pass/watch rated credits, and increasing balances/concentrations in certain segments of the loan portfolio. Creating this new pool, increased the provision for loan losses by \$1.4 million compared to the prior methodology.

The following table represents the effect on the loan loss provision as a result of these changes in methodology. It compares the methodology actually used for the year ended December 31, 2017 to that used in prior periods.

(Dollars in thousands)	Calculated Provision Based on Current Methodology	Calculated Provision Based on Prior Methodology	Difference
Construction	\$ (303)	\$ (653)	\$ 350
Residential real estate	736	753	(17)
Commercial real estate	53	(439)	492
Commercial	1,827	1,217	610
Consumer	(22)	(9)	(13)
Total	\$ 2,291	\$ 869	\$ 1,422

The allowance for loan losses was 0.89% of total loans at December 31, 2017, compared to 1.00% at December 31, 2016.

The following tables provide information on impaired loans and any related allowance by loan class as of December 31, 2017 and 2016. The difference between the unpaid principal balance and the recorded investment is the amount of partial charge-offs that have been taken.

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Average recorded investment	Interest income recognized
December 31, 2017						
Impaired nonaccrual loans:						
Construction	\$ 3,100	\$ 182	\$ 2,821	\$ 459	\$ 3,181	\$ -
Residential real estate	1,620	1,482	-	-	3,191	-
Commercial real estate	795	149	-	-	542	-
Commercial	425	-	337	33	200	-
Consumer	-	-	-	-	41	-
Total	\$ 5,940	\$ 1,813	\$ 3,158	\$ 492	\$ 7,155	\$ -
Impaired accruing TDRs:						
Construction	\$ 3,972	\$ 3,038	\$ 934	\$ 41	\$ 4,067	\$ 101
Residential real estate	4,536	2,042	2,494	239	3,831	161
Commercial real estate	4,818	4,084	734	33	4,860	185
Commercial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$ 13,326	\$ 9,164	\$ 4,162	\$ 313	\$ 12,758	\$ 447
Total impaired loans:						
Construction	\$ 7,072	\$ 3,220	\$ 3,755	\$ 500	\$ 7,248	\$ 101
Residential real estate	6,156	3,524	2,494	239	7,022	161
Commercial real estate	5,613	4,233	734	33	5,402	185
Commercial	425	-	337	33	200	-
Consumer	-	-	-	-	41	-
Total	\$ 19,266	\$ 10,977	\$ 7,320	\$ 805	\$ 19,913	\$ 447

(Dollars in thousands)	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Average recorded investment	Interest income recognized
December 31, 2016						
Impaired nonaccrual loans:						
Construction	\$ 7,247	\$ -	\$ 3,818	\$ 1,621	\$ 5,707	\$ -
Residential real estate	4,013	1,957	1,946	166	3,500	-
Commercial real estate	1,801	959	193	117	2,144	-
Commercial	-	-	-	-	108	-
Consumer	99	99	-	-	106	-
Total	\$ 13,160	\$ 3,015	\$ 5,957	\$ 1,904	\$ 11,565	\$ -
Impaired accruing TDRs:						
Construction	\$ 4,189	\$ 3,479	\$ 710	\$ 18	\$ 4,172	\$ 96
Residential real estate	3,875	2,829	1,046	151	4,663	195
Commercial real estate	4,936	1,573	3,363	68	5,090	174
Commercial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	\$ 13,000	\$ 7,881	\$ 5,119	\$ 237	\$ 13,925	\$ 465
Total impaired loans:						
Construction	\$ 11,436	\$ 3,479	\$ 4,528	\$ 1,639	\$ 9,879	\$ 96
Residential real estate	7,888	4,786	2,992	317	8,163	195
Commercial real estate	6,737	2,532	3,556	185	7,234	174
Commercial	-	-	-	-	108	-
Consumer	99	99	-	-	106	-
Total	\$ 26,160	\$ 10,896	\$ 11,076	\$ 2,141	\$ 25,490	\$ 465

The following tables provide a roll-forward for troubled debt restructurings as of December 31, 2017 and December 31, 2016.

(Dollars in thousands)	1/1/2017						12/31/2017	
	TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassifications/ Transfer In/(Out)	Payoffs	TDR Balance	Related Allowance
For the year ended December 31, 2017								
Accruing TDRs								
Construction	\$4,189	\$-	\$ (25)	\$ -	\$ (58)	\$ (134)	\$3,972	\$ 41
Residential real estate	3,875	-	(333)	(89)	1,535	(452)	4,536	239
Commercial real estate	4,936	-	(118)	-	-	-	4,818	33
Commercial	-	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-	-
Total	\$13,000	\$-	\$ (476)	\$ (89)	\$ 1,477	\$ (586)	\$13,326	\$ 313
Nonaccrual TDRs								
Construction	\$3,818	\$-	\$ (890)	\$ -	\$ (50)	\$ -	\$2,878	\$ 459
Residential real estate	1,603	-	(68)	-	(1,535)	-	-	-
Commercial real estate	83	-	-	-	-	-	83	-
Commercial	-	345	(8)	-	-	-	337	33
Consumer	-	-	-	-	-	-	-	-
Total	\$5,504	\$345	\$ (966)	\$ -	\$ (1,585)	\$ -	\$3,298	\$ 492
Total	\$18,504	\$345	\$ (1,442)	\$ (89)	\$ (108)	\$ (586)	\$16,624	\$ 805
For the year ended December 31, 2016								
Accruing TDRs								
Construction	\$4,069	\$-	\$ 120	\$ -	\$ -	\$ -	\$4,189	\$ 18
Residential real estate	5,686	565	(405)	-	(1,595)	(376)	3,875	151
Commercial real estate	5,740	495	(724)	(117)	(458)	-	4,936	68
Commercial	-	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-	-
Total	\$15,495	\$1,060	\$ (1,009)	\$ (117)	\$ (2,053)	\$ (376)	\$13,000	\$ 237
Nonaccrual TDRs								
Construction	\$4,960	\$2,570	\$ (2,022)	\$ (590)	\$ (1,100)	\$ -	\$3,818	\$ 1,621
Residential real estate	445	117	(531)	(23)	1,595	-	1,603	156

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Commercial real estate	-	-	(117)	(258)	458	-	83	-
Commercial	-	-	-	-	-	-	-	-	-
Consumer	23	-	(23)	-	-	-	-	-
Total	\$5,428	\$2,687	\$ (2,693)	\$(871)	\$ 953	\$-	\$5,504	\$ 1,777
Total	\$20,923	\$3,747	\$ (3,702)	\$(988)	\$ (1,100)	\$(376)	\$18,504 \$ 2,014

The following tables provide information on loans that were modified and considered TDRs during 2017 and 2016.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment	Related allowance
TDRs:				
For the year ended December 31, 2017				
Construction	-	\$ -	\$ -	\$ -
Residential real estate	-	-	-	-
Commercial real estate	1	760	755	-
Commercial	1	462	345	-
Consumer	-	-	-	-
Total	2	\$ 1,222	\$ 1,100	\$ -
For the year ended December 31, 2016				
Construction	-	\$ -	\$ -	\$ -
Residential real estate	3	667	688	-
Commercial real estate	2	695	572	-
Commercial	-	-	-	-
Consumer	-	-	-	-
Total	5	\$ 1,362	\$ 1,260	\$ -

During the year ended December 31, 2017, there was one new TDR and one previously recorded TDR which was modified. The new TDR consisted of a reduction in principal, whereas, the previously recorded TDR consisted of a change in maturity date.

The following tables provide information on TDRs that defaulted during 2017 and 2016. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is placed on nonaccrual, charged-off, or foreclosure proceedings have commenced.

(Dollars in thousands)	Number of contracts	Recorded investment	Related allowance
TDRs that subsequently defaulted:			
For the year ended December 31, 2017			
Construction	-	\$ -	\$ -
Residential real estate	1	89	-
Commercial real estate	-	-	-
Commercial	-	-	-
Consumer	-	-	-

Total	1	\$ 89	\$ -
For the year ended December 31, 2016			
Construction	2	\$ 590	\$ -
Residential real estate	1	23	-
Commercial real estate	2	375	-
Commercial	-	-	-
Consumer	-	-	-
Total	5	\$ 988	\$ -

Management uses risk ratings as part of its monitoring of the credit quality in the Company's loan portfolio. Loans that are identified as special mention, substandard or doubtful are adversely rated. They are assigned higher risk ratings than favorably rated loans in the calculation of the formula portion of the allowance for credit losses along with loans rated pass/watch which are deemed to have higher credit risk than the remainder of the pass categories. At December 31, 2017, there were no nonaccrual loans classified as special mention or doubtful and \$5.0 million of nonaccrual loans were identified as substandard. The comparable amounts at December 31, 2016 were special mention \$0, substandard \$9.0 million and doubtful \$0, respectively.

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The following tables provide information on loan risk ratings as of December 31, 2017 and 2016.

(Dollars in thousands)	Pass/Performing	Pass/Watch	Special Mention	Substandard	Doubtful	Total
December 31, 2017						
Construction	\$ 88,836	\$ 30,674	\$-	\$ 6,236	\$ -	\$125,746
Residential real estate	355,575	34,973	4,456	4,186	-	399,190
Commercial real estate	342,051	109,041	7,420	6,375	-	464,887
Commercial	72,440	24,102	308	434	-	97,284
Consumer	5,260	1,147	-	-	-	6,407
Total	\$ 864,162	\$ 199,937	\$ 12,184	\$ 17,231	\$ -	\$1,093,514

(Dollars in thousands)	Pass/Performing	Pass/Watch	Special Mention	Substandard	Doubtful	Total
December 31, 2016						
Construction	\$ 45,126	\$ 27,515	\$4,195	\$ 7,166	\$ -	\$84,002
Residential real estate	280,215	32,027	6,646	6,880	-	325,768
Commercial real estate	260,935	102,526	10,939	8,281	-	382,681
Commercial	49,697	21,616	857	265	-	72,435
Consumer	6,406	134	-	99	-	6,639
Total	\$ 642,379	\$ 183,818	\$ 22,637	\$ 22,691	\$ -	\$871,525

The following tables provide information on the aging of the loan portfolio as of December 31, 2017 and 2016.

(Dollars in thousands)	Accruing Current	Accruing			Total past due	Nonaccrual	Total
		30-59 days past due	60-89 days past due	Greater than 90 days			
December 31, 2017							
Construction	\$122,475	\$ 268	\$ -	\$ -	\$ 268	\$ 3,003	\$125,746
Residential real estate	394,653	1,589	1,045	421	3,055	1,482	399,190
Commercial real estate	460,998	1,061	2,461	218	3,740	149	464,887
Commercial	96,774	173	-	-	173	337	97,284
Consumer	6,395	6	6	-	12	-	6,407
Total	\$1,081,295	\$ 3,097	\$ 3,512	\$ 639	\$ 7,248	\$ 4,971	\$1,093,514
Percent of total loans	98.8	% 0.3	% 0.3	% 0.1	% 0.7	% 0.5	% 100.0

(Dollars in thousands)	Accruing Current	Accruing			Total past due	Nonaccrual	Total
		30-59 days past due	60-89 days past due	Greater than 90 days			

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December 31, 2016

Construction	\$80,079	\$ -	\$ 105	\$ -	\$105	\$ 3,818	\$84,002
Residential real estate	317,992	1,778	2,095	-	3,873	3,903	325,768
Commercial real estate	375,552	3,219	2,758	-	5,977	1,152	382,681
Commercial	72,272	19	134	10	163	-	72,435
Consumer	6,515	13	2	10	25	99	6,639
Total	\$852,410	\$ 5,029	\$ 5,094	\$ 20	\$10,143	\$ 8,972	\$871,525
Percent of total loans	97.8						