

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2017

OR

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

For the transition period from _____ to _____

Commission file number 0-22345

SHORE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

<u>Maryland</u> (State or Other Jurisdiction of Incorporation or Organization)	<u>52-1974638</u> (I.R.S. Employer Identification No.)
<u>28969 Information Lane, Easton, Maryland</u> (Address of Principal Executive Offices)	<u>21601</u> (Zip Code)

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

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

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

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

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

Large accelerated filer	☐	Accelerated filer	☒
Non-accelerated filer	☐	Smaller reporting company	☐
(Do not check if a smaller reporting company)		Emerging growth company	☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date : 12,688,224 shares of common stock outstanding as of October 31, 2017.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.

SHORE BANCSHARES, INC. CONSOLIDATED BALANCE SHEETS (Dollars in thousands, except per share amounts)

	September 30, 2017	December 31, 2016
ASSETS	(Unaudited)	
Cash and due from banks	\$ 22,315	\$ 14,596
Interest-bearing deposits with other banks	21,601	61,342
Cash and cash equivalents	43,916	75,938
Investment securities:		
Available-for-sale, at fair value	213,390	163,902
Held to maturity, at amortized cost - fair value of \$6,451 (2017) and \$6,806 (2016)	6,241	6,704
Loans	1,047,247	871,525
Less: allowance for credit losses	(9,295)	(8,726)
Loans, net	1,037,952	862,799
Premises and equipment, net	23,124	16,558
Goodwill	27,909	11,931
Other intangible assets, net	4,831	1,079
Other real estate owned, net	1,809	2,477
Other assets	16,955	18,883
TOTAL ASSETS	\$ 1,376,127	\$ 1,160,271
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 326,020	\$ 261,575
Interest-bearing	880,175	735,914
Total deposits	1,206,195	997,489
Short-term borrowings	1,469	3,203
Other liabilities	5,815	5,280
TOTAL LIABILITIES	1,213,479	1,005,972
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, par value \$.01 per share; shares authorized - 35,000,000 ; shares issued and outstanding - 12,686,767 (including 15,913 unvested restricted stock) (2017) and 12,664,797 (including 12,488 unvested restricted stock) (2016)	127	127
Additional paid in capital	64,949	64,201
Retained earnings	97,626	90,964
Accumulated other comprehensive (loss)	(54)	(993)
TOTAL STOCKHOLDERS' EQUITY	162,648	154,299
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,376,127	\$ 1,160,271

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Dollars in thousands, except per share amounts)

	For Three Months Ended September 30,		For Nine Months Ended September 30,	
	2017	2016	2017	2016
INTEREST INCOME				
Interest and fees on loans	\$ 11,771	\$ 9,398	\$ 31,762	\$ 27,476
Interest and dividends on investment securities:				
Taxable	1,035	754	2,799	2,448
Tax-exempt	-	2	3	6
Interest on federal funds sold	-	1	-	6
Interest on deposits with other banks	131	81	269	211
Total interest income	12,937	10,236	34,833	30,147
INTEREST EXPENSE				
Interest on deposits	607	574	1,656	1,852
Interest on short-term borrowings	4	4	18	11
Total interest expense	611	578	1,674	1,863
NET INTEREST INCOME	12,326	9,658	33,159	28,284
Provision for credit losses	345	605	1,746	1,430
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	11,981	9,053	31,413	26,854
NONINTEREST INCOME				
Service charges on deposit accounts	945	899	2,657	2,582
Trust and investment fee income	389	358	1,122	1,073
Gains on sales and calls of investment securities	5	30	5	31
Insurance agency commissions	2,088	2,054	6,939	6,754
Other noninterest income	998	666	2,688	2,149
Total noninterest income	4,425	4,007	13,411	12,589
NONINTEREST EXPENSE				
Salaries and wages	5,203	4,346	14,508	13,245
Employee benefits	1,197	1,009	3,564	3,087
Occupancy expense	696	643	1,950	1,839
Furniture and equipment expense	286	245	803	728
Data processing	922	976	2,809	2,639
Directors' fees	99	120	281	355
Amortization of other intangible assets	115	33	203	99
FDIC insurance premium expense	189	104	398	654
Other real estate owned expense, net	136	2	299	75
Legal and professional	493	440	1,855	1,434
Other noninterest expenses	1,384	1,299	3,900	3,766
Total noninterest expense	10,720	9,217	30,570	27,921
INCOME BEFORE INCOME TAXES	5,686	3,843	14,254	11,522
Income tax expense	2,274	1,432	5,690	4,379
NET INCOME	\$ 3,412	\$ 2,411	\$ 8,564	\$ 7,143
Earnings per common share - Basic	\$ 0.27	\$ 0.19	\$ 0.68	\$ 0.56
Earnings per common share - Diluted	0.27	0.19	0.67	0.56
Dividends paid per common share	0.05	0.03	0.15	0.09

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(Dollars in thousands)

	For Three Months Ended September 30,		For Nine Months Ended September 30,	
	<u>2017</u>	<u>2016</u>	<u>2017</u>	<u>2016</u>
Net Income	<u>\$ 3,412</u>	<u>\$ 2,411</u>	<u>\$ 8,564</u>	<u>\$ 7,143</u>
Other comprehensive (loss) income:				
Investment securities:				
Unrealized holding (losses) gains on available-for-sale-securities	(385)	617	1,555	2,628
Tax effect	155	(250)	(628)	(1,062)
Reclassification of (gains) recognized				
in net income	(5)	(30)	(5)	(31)
Tax effect	2	12	2	13
Amortization of unrealized loss on securities transferred from				
available-for-sale to held-to-maturity	8	-	23	-
Tax effect	(3)	-	(8)	-
Net of tax amount	<u>(228)</u>	<u>349</u>	<u>939</u>	<u>1,548</u>
Total other comprehensive (loss) income	<u>(228)</u>	<u>349</u>	<u>939</u>	<u>1,548</u>
Comprehensive income	<u>\$ 3,184</u>	<u>\$ 2,760</u>	<u>\$ 9,503</u>	<u>\$ 8,691</u>

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Nine Months Ended September 30, 2017 and 2016
(Dollars in thousands)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances, January 1, 2017	\$ 127	\$ 64,201	\$ 90,964	\$ (993)	\$ 154,299
Net Income	-	-	8,564	-	8,564
Other comprehensive income	-	-	-	939	939
Stock-based compensation	-	748	-	-	748
Cash dividends declared	-	-	(1,902)	-	(1,902)
Balances, September 30, 2017	\$ 127	\$ 64,949	\$ 97,626	\$ (54)	\$ 162,648
Balances, January 1, 2016	\$ 126	\$ 63,815	\$ 83,097	\$ (71)	\$ 146,967
Net Income	-	-	7,143	-	7,143
Other comprehensive income	-	-	-	1,548	1,548
Common shares issued for employee stock-based awards	-	53	-	-	53
Stock-based compensation	1	261	-	-	262
Cash dividends declared	-	-	(1,138)	-	(1,138)
Balances, September 30, 2016	\$ 127	\$ 64,129	\$ 89,102	\$ 1,477	\$ 154,835

See accompanying notes to Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

	For Nine Months Ended September 30,	
	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	\$ 8,564	\$ 7,143
Adjustments to reconcile net income to net cash provided by operating activities:		
Net accretion of acquisition accounting estimates	(347)	-
Provision for credit losses	1,746	1,430
Depreciation and amortization	1,195	1,856
Net amortization of securities	612	(17)
Stock-based compensation expense	748	262
Deferred income tax expense	3,075	4,008
(Gains) on sales of securities	(5)	(31)
Losses on disposals of premises and equipment	2	-
(Gains) losses on sales of other real estate owned	(3)	125
Write-downs of other real estate owned	296	75
Net changes in:		
Accrued interest receivable	(447)	(15)
Other assets	(2,236)	(1,602)
Accrued interest payable	(15)	(32)
Other liabilities	543	(272)
Net cash provided by operating activities	13,728	12,930
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of investment securities available for sale	35,957	47,373
Proceeds from sales of securities available for sale	-	3,961
Purchases of investment securities available for sale	(84,495)	(12,142)
Proceeds from maturities and principal payments of investment securities held to maturity	479	376
Net change in loans	(53,834)	(68,171)
Purchases of premises and equipment	(1,035)	(542)
Proceeds from sales of other real estate owned	470	3,454
Cash received in branch acquisition (net of cash paid)	64,045	-
Net cash used in investing activities	(38,413)	(25,691)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net changes in:		
Noninterest-bearing deposits	29,883	26,874
Interest-bearing deposits	(33,584)	(10,042)
Short-term borrowings	(1,734)	(1,672)
Proceeds from the issuance of common stock	-	53
Common stock dividends paid	(1,902)	(1,138)
Net cash (used in) provided by financing activities	(7,337)	14,075
Net (decrease) increase in cash and cash equivalents	(32,022)	1,314
Cash and cash equivalents at beginning of period	75,938	73,811
Cash and cash equivalents at end of period	\$ 43,916	\$ 75,125

Supplemental cash flows information:

Interest paid	\$ 1,738	\$ 1,895
Income taxes paid	\$ 2,000	\$ 588
Transfers from loans to other real estate owned	\$ 95	\$ 1,599
Change in unrealized gains on securities available for sale	\$ 1,550	\$ 2,596
Amortization of unrealized loss on securities transferred from available for sale to held to maturity	\$ 23	\$ -

Branch purchase:

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

See accompanying notes to Consolidated Financial Statements.

Shore Bancshares, Inc.
Notes to Consolidated Financial Statements
For the Three and Nine Months Ended September 30, 2017 and 2016
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America (“GAAP”) and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the consolidated financial position at September 30, 2017, the consolidated results of income and comprehensive income for the three and nine months ended September 30, 2017 and 2016, and changes in stockholders’ equity and cash flows for the nine months ended September 30, 2017 and 2016, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2016 were derived from the 2016 audited financial statements. The results of operations for the three and nine months ended September 30, 2017 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2016. For purposes of comparability, certain immaterial reclassifications have been made to amounts previously reported to conform with the current period presentation.

When used in these notes, the term “the Company” refers to Shore Bancshares, Inc. and, unless the context requires otherwise, its consolidated subsidiaries.

Reclassification

During the period of September 30, 2017, management made an immaterial reclassification adjustment to goodwill and deferred income taxes for a transaction involving a stock-based acquisition of an insurance entity which occurred in 2007. This reclassification was deemed an immaterial correction of an error as it had no impact on total assets or earnings per share previously reported in the Consolidated Balance Sheets and Consolidated Statements of Income for any period but was necessary in order to properly reflect goodwill and deferred income taxes on the Company’s consolidated balance sheet.

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 and the management discussion and analysis section, the term “the Bank” refers to Shore United Bank, unless the context requires stipulating results of the individual banks before the consolidation occurred.

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.

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.

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.

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 Northwest, the Bank received a cash payment from Northwest of \$64.0 million, which was net of a premium paid on deposits of \$17.2 million. 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.

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 \$15.3 million recorded from the acquisition:
(in thousands)

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
Total fair value of assets acquired	\$	214,373

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:	\$	1,910
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Transaction consideration paid to Northwest Bank	\$	17,186
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Amount of goodwill resulting from acquisition	\$	15,276
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The total amount of goodwill arising from this transaction of \$15.3 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
Performing loans acquired	<u>\$ 125,131</u>	<u>125,131</u>	<u>2,269</u>	<u>\$ 122,862</u>

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 – Earnings Per Share

Basic earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per common share is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period, adjusted for the dilutive effect of common stock equivalents (stock-based awards). The following table provides information relating to the calculation of earnings per common share:

(In thousands, except per share data)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2017	2016	2017	2016
Net Income	\$ 3,412	\$ 2,411	\$ 8,564	\$ 7,143
Weighted average shares outstanding - Basic	12,687	12,661	12,679	12,648
Dilutive effect of common stock equivalents-options	21	-	21	-
Dilutive effect of common stock equivalents-restricted stock units	8	15	6	15
Weighted average shares outstanding - Diluted	12,716	12,676	12,706	12,663
Earnings per common share - Basic	\$ 0.27	\$ 0.19	\$ 0.68	\$ 0.56
Earnings per common share - Diluted	\$ 0.27	\$ 0.19	\$ 0.67	\$ 0.56

There were no weighted average common stock equivalents excluded from the calculation of diluted earnings per share for the three and nine months ended September 30, 2017 and 2016 .

Note 4 – 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:				
September 30, 2017				
U.S. Government agencies	\$ 52,093	\$ 64	\$ 154	\$ 52,003
Mortgage-backed	160,645	660	580	160,725
Equity	662	-	-	662
Total	\$ 213,400	\$ 724	\$ 734	\$ 213,390
December 31, 2016				
U.S. Government agencies	\$ 34,320	\$ 56	\$ 58	\$ 34,318
Mortgage-backed	130,490	263	1,809	128,944
Equity	652	-	12	640
Total	\$ 165,462	\$ 319	\$ 1,879	\$ 163,902
Held-to-maturity securities:				
September 30, 2017				
U.S. Government agencies	\$ 1,837	\$ 42	\$ -	\$ 1,879
States and political subdivisions	1,404	61	-	1,465
Other debt securities (1)	3,000	107	-	3,107
Total	\$ 6,241	\$ 210	\$ -	\$ 6,451
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 with a fixed to floating rate of 6.5% from a local regional bank which it intends to hold to maturity of December 30, 2026.

The following tables provide 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 September 30, 2017 and December 31, 2016.

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in thousands)						
September 30, 2017						
Available-for-sale securities:						
U.S. Government agencies	\$ 40,819	\$ 150	\$ 2,998	\$ 4	\$ 43,817	\$ 154
Mortgage-backed	60,113	289	11,086	291	71,199	580
Total	<u>\$ 100,932</u>	<u>\$ 439</u>	<u>\$ 14,084</u>	<u>\$ 295</u>	<u>\$ 115,016</u>	<u>\$ 734</u>

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(Dollars in thousands)						
December 31, 2016						
Available-for-sale securities:						
U.S. Government agencies	\$ 11,926	\$ 58	\$ -	\$ -	\$ 11,926	\$ 58
Mortgage-backed	100,237	1,546	9,208	263	109,445	1,809
Equity securities	640	12	-	-	640	12
Total	<u>\$ 112,803</u>	<u>\$ 1,616</u>	<u>\$ 9,208</u>	<u>\$ 263</u>	<u>\$ 122,011</u>	<u>\$ 1,879</u>

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. 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.

The following table provides information on the amortized cost and estimated fair values of investment securities by maturity date at September 30, 2017.

	Available for sale		Held to maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
(Dollars in thousands)				
Due in one year or less	\$ 9,000	\$ 8,996	\$ -	\$ -
Due after one year through five years	40,973	40,831	902	946
Due after five years through ten years	34,242	34,241	3,502	3,626
Due after ten years	128,523	128,660	1,837	1,879
	212,738	212,728	6,241	6,451
Equity securities	662	662	-	-
Total	<u>\$ 213,400</u>	<u>\$ 213,390</u>	<u>\$ 6,241</u>	<u>\$ 6,451</u>

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

Note 5 – Loans and Allowance for Credit Losses

The Company makes residential mortgage, commercial and consumer loans to customers primarily in Talbot County, Queen Anne’s County, Kent County, Caroline County, Dorchester County, Baltimore County and Howard County in Maryland, Kent County, Delaware and Accomack County, Virginia. The following table provides information about the principal classes of the loan portfolio at September 30, 2017 and December 31, 2016.

(Dollars in thousands)	September 30, 2017	December 31, 2016
Construction	\$ 106,617	\$ 84,002
Residential real estate	387,722	325,768
Commercial real estate	454,626	382,681
Commercial	91,799	72,435
Consumer	6,483	6,639
Total loans	1,047,247	871,525
Allowance for credit losses	(9,295)	(8,726)
Total loans, net	\$ 1,037,952	\$ 862,799

Loans are stated at their principal amount outstanding net of any purchase premiums, deferred fees and costs. Loans included deferred costs, net of deferred fees, of \$632 thousand and discounts on acquired loans of \$2.0 million at September 30, 2017. Loans included deferred costs, net of deferred fees, of \$509 thousand at December 31, 2016. 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 homogenous 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 are included in the formula portion of the allowance for credit losses. See additional discussion under the caption “Critical Accounting Policies” in Management’s Discussion and Analysis of Financial Condition and Results of Operations.

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, Shore United Bank (the “Bank”), 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.

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 September 30, 2017 and December 31, 2016.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
September 30, 2017						
Loans individually						
evaluated for impairment	\$ 6,986	\$ 7,190	\$ 5,265	\$ 341	\$ -	\$ 19,782
Loans collectively						
evaluated for impairment	99,631	380,532	449,361	91,458	6,483	1,027,465
Total loans	<u>\$ 106,617</u>	<u>\$ 387,722</u>	<u>\$ 454,626</u>	<u>\$ 91,799</u>	<u>\$ 6,483</u>	<u>\$ 1,047,247</u>
Allowance for credit losses allocated to:						
Loans individually						
evaluated for impairment	\$ 589	\$ 251	\$ 35	\$ -	\$ -	\$ 875
Loans collectively						
evaluated for impairment	1,652	1,792	2,849	1,804	323	8,420
Total allowance	<u>\$ 2,241</u>	<u>\$ 2,043</u>	<u>\$ 2,884</u>	<u>\$ 1,804</u>	<u>\$ 323</u>	<u>\$ 9,295</u>
(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Total
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	<u>\$ 84,002</u>	<u>\$ 325,768</u>	<u>\$ 382,681</u>	<u>\$ 72,435</u>	<u>\$ 6,639</u>	<u>\$ 871,525</u>
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 allowance	<u>\$ 2,787</u>	<u>\$ 1,953</u>	<u>\$ 2,610</u>	<u>\$ 1,145</u>	<u>\$ 231</u>	<u>\$ 8,726</u>

The following tables provide information on impaired loans and any related allowance by loan class as of September 30, 2017 and December 31, 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	Quarter-to- date average recorded investment	Year-to-date average recorded investment	Interest income recognized
September 30, 2017							
Impaired nonaccrual loans:							
Construction	\$ 3,035	\$ 125	\$ 2,828	\$ 548	\$ 2,890	\$ 3,253	\$ -
Residential real estate	2,736	2,439	126	23	2,840	3,573	-
Commercial real estate	1,075	430	-	-	489	627	-
Commercial	425	341	-	-	344	153	-
Consumer	-	-	-	-	-	55	-
Total	<u>\$ 7,271</u>	<u>\$ 3,335</u>	<u>\$ 2,954</u>	<u>\$ 571</u>	<u>\$ 6,563</u>	<u>\$ 7,661</u>	<u>\$ -</u>
Impaired accruing TDRs:							
Construction	\$ 4,033	\$ 3,098	\$ 935	\$ 41	\$ 4,034	\$ 4,086	\$ 82
Residential real estate	4,625	2,190	2,435	228	3,691	3,620	117
Commercial real estate	4,835	4,094	741	35	4,841	4,872	145
Commercial	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-
Total	<u>\$ 13,493</u>	<u>\$ 9,382</u>	<u>\$ 4,111</u>	<u>\$ 304</u>	<u>\$ 12,566</u>	<u>\$ 12,578</u>	<u>\$ 344</u>
Total impaired loans:							
Construction	\$ 7,068	\$ 3,223	\$ 3,763	\$ 589	\$ 6,924	\$ 7,339	\$ 82
Residential real estate	7,361	4,629	2,561	251	6,531	7,193	117
Commercial real estate	5,910	4,524	741	35	5,330	5,499	145
Commercial	425	341	-	-	344	153	-
Consumer	-	-	-	-	-	55	-
Total	<u>\$ 20,764</u>	<u>\$ 12,717</u>	<u>\$ 7,065</u>	<u>\$ 875</u>	<u>\$ 19,129</u>	<u>\$ 20,239</u>	<u>\$ 344</u>

(Dollars in thousands)	September 30, 2016						
	Unpaid principal balance	Recorded investment with no allowance	Recorded investment with an allowance	Related allowance	Quarter-to- date average recorded investment	Year-to-date average recorded investment	Interest income recognized
December 31, 2016							
Impaired nonaccrual loans:							
Construction	\$ 7,247	\$ -	\$ 3,818	\$ 1,621	\$ 5,361	\$ 6,022	\$ -
Residential real estate	4,013	1,957	1,946	166	4,012	3,406	-
Commercial real estate	1,801	959	193	117	2,177	2,265	-
Commercial	-	-	-	-	108	143	-
Consumer	99	99	-	-	99	109	-
Total	<u>\$ 13,160</u>	<u>\$ 3,015</u>	<u>\$ 5,957</u>	<u>\$ 1,904</u>	<u>\$ 11,757</u>	<u>\$ 11,945</u>	<u>\$ -</u>
Impaired accruing TDRs:							
Construction	\$ 4,189	\$ 3,479	\$ 710	\$ 18	\$ 4,213	\$ 4,166	\$ 74
Residential real estate	3,875	2,829	1,046	151	4,100	4,900	149
Commercial real estate	4,936	1,573	3,363	68	4,982	5,137	127
Commercial	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-
Total	<u>\$ 13,000</u>	<u>\$ 7,881</u>	<u>\$ 5,119</u>	<u>\$ 237</u>	<u>\$ 13,295</u>	<u>\$ 14,203</u>	<u>\$ 350</u>
Total impaired loans:							
Construction	\$ 11,436	\$ 3,479	\$ 4,528	\$ 1,639	\$ 9,574	\$ 10,188	\$ 74
Residential real estate	7,888	4,786	2,992	317	8,112	8,306	149
Commercial real estate	6,737	2,532	3,556	185	7,159	7,402	127
Commercial	-	-	-	-	108	143	-
Consumer	99	99	-	-	99	109	-
Total	<u>\$ 26,160</u>	<u>\$ 10,896</u>	<u>\$ 11,076</u>	<u>\$ 2,141</u>	<u>\$ 25,052</u>	<u>\$ 26,148</u>	<u>\$ 350</u>

The following tables provide a roll-forward for troubled debt restructurings as of September 30, 2017 and September 30, 2016.

(Dollars in thousands)	1/1/2017 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassifications/ Transfer In/(Out)	Payoffs	9/30/2017 TDR Balance	Related Allowance
For nine months ended September 30, 2017								
Accruing TDRs								
Construction	\$ 4,189	\$ -	\$ (22)	\$ -	\$ -	\$ (134)	\$ 4,033	\$ 41
Residential real estate	3,875	-	(120)	(89)	1,411	(452)	4,625	228
Commercial real estate	4,936	-	(101)	-	-	-	4,835	35
Commercial	-	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-	-
Total	<u>\$ 13,000</u>	<u>\$ -</u>	<u>\$ (243)</u>	<u>\$ (89)</u>	<u>\$ 1,411</u>	<u>\$ (586)</u>	<u>\$ 13,493</u>	<u>\$ 304</u>
Nonaccrual TDRs								
Construction	\$ 3,818	\$ -	\$ (882)	\$ -	\$ (108)	\$ -	\$ 2,828	\$ 548
Residential real estate	1,603	-	(66)	-	(1,411)	-	126	23
Commercial real estate	83	-	-	-	-	-	83	-
Commercial	-	345	(4)	-	-	-	341	-
Consumer	-	-	-	-	-	-	-	-
Total	<u>\$ 5,504</u>	<u>\$ 345</u>	<u>\$ (952)</u>	<u>\$ -</u>	<u>\$ (1,519)</u>	<u>\$ -</u>	<u>\$ 3,378</u>	<u>\$ 571</u>
Total	<u>\$ 18,504</u>	<u>\$ 345</u>	<u>\$ (1,195)</u>	<u>\$ (89)</u>	<u>\$ (108)</u>	<u>\$ (586)</u>	<u>\$ 16,871</u>	<u>\$ 875</u>

(Dollars in thousands)	1/1/2016 TDR Balance	New TDRs	Disbursements (Payments)	Charge offs	Reclassifications/ Transfer In/(Out)	Payoffs	9/30/2016 TDR Balance	Related Allowance
For nine months ended September 30, 2016								
Accruing TDRs								
Construction	\$ 4,069	\$ -	\$ 130	\$ -	\$ -	\$ -	\$ 4,199	\$ 21
Residential real estate	5,686	565	(375)	-	(1,595)	(179)	4,102	154
Commercial real estate	5,740	495	(689)	(117)	(458)	-	4,971	89
Commercial	-	-	-	-	-	-	-	-
Consumer	-	-	-	-	-	-	-	-
Total	<u>\$ 15,495</u>	<u>\$ 1,060</u>	<u>\$ (934)</u>	<u>\$ (117)</u>	<u>\$ (2,053)</u>	<u>\$ (179)</u>	<u>\$ 13,272</u>	<u>\$ 264</u>
Nonaccrual TDRs								
Construction	\$ 4,960	\$ 2,570	\$ (2,012)	\$ (263)	\$ -	\$ -	\$ 5,255	\$ 810
Residential real estate	445	-	(294)	-	1,595	-	1,746	25
Commercial real estate	-	-	-	(258)	458	-	200	112
Commercial	-	-	-	-	-	-	-	-
Consumer	23	-	(23)	-	-	-	-	-
Total	<u>\$ 5,428</u>	<u>\$ 2,570</u>	<u>\$ (2,329)</u>	<u>\$ (521)</u>	<u>\$ 2,053</u>	<u>\$ -</u>	<u>\$ 7,201</u>	<u>\$ 947</u>
Total	<u>\$ 20,923</u>	<u>\$ 3,630</u>	<u>\$ (3,263)</u>	<u>\$ (638)</u>	<u>\$ -</u>	<u>\$ (179)</u>	<u>\$ 20,473</u>	<u>\$ 1,211</u>

The following tables provide information on loans that were modified and considered TDRs during the nine months ended September 30, 2017 and September 30, 2016.

(Dollars in thousands)	Number of contracts	Premodification outstanding recorded investment	Postmodification outstanding recorded investment	Related allowance
TDRs:				
For nine months ended				
September 30, 2017				
Construction	-	\$ -	\$ -	\$ -
Residential real estate	-	-	-	-
Commercial real estate	1	760	755	-
Commercial	1	462	345	-
Consumer	-	-	-	-
Total	2	\$ 1,222	\$ 1,100	\$ -
For nine months ended				
September 30, 2016				
Construction	-	\$ -	\$ -	\$ -
Residential real estate	3	667	699	-
Commercial real estate	1	495	495	-
Commercial	-	-	-	-
Consumer	-	-	-	-
Total	4	\$ 1,162	\$ 1,194	\$ -

During the nine months ended September 30, 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 within twelve months of restructuring during the nine months ended September 30, 2017 and September 30, 2016. Generally, a loan is considered in default when principal or interest is past due 90 days or more, the loan is charged off, or there is a transfer to OREO or repossessed assets.

(Dollars in thousands)	Number of contracts	Recorded investment	Related allowance
TDRs that subsequently defaulted:			
For nine months ended			
September 30, 2017			
Construction	-	\$ -	\$ -
Residential real estate	1	89	-
Commercial real estate	-	-	-
Commercial	-	-	-
Consumer	-	-	-
Total	1	\$ 89	\$ -
For nine months ended			
September 30, 2016			
Construction	1	\$ 263	\$ -
Residential real estate	-	-	-
Commercial real estate	2	375	-
Commercial	-	-	-
Consumer	-	-	-
Total	3	\$ 638	\$ -

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. At September 30, 2017, there were no nonaccrual loans classified as special mention or doubtful and \$6.3 million of nonaccrual loans were identified as substandard. Similarly, at December 31, 2016, there were no nonaccrual loans classified as special mention or doubtful and \$9.0 million of nonaccrual loans were identified as substandard.

The following tables provide information on loan risk ratings as of September 30, 2017 and December 31, 2016.

(Dollars in thousands)	Pass/Performing	Special Mention	Substandard	Doubtful	Total
September 30, 2017					
Construction	\$ 97,304	\$ 3,127	\$ 6,186	\$ -	\$ 106,617
Residential real estate	376,600	5,509	5,613	-	387,722
Commercial real estate	438,694	6,780	9,152	-	454,626
Commercial	90,680	660	459	-	91,799
Consumer	6,483	-	-	-	6,483
Total	<u>\$ 1,009,761</u>	<u>\$ 16,076</u>	<u>\$ 21,410</u>	<u>\$ -</u>	<u>\$ 1,047,247</u>

(Dollars in thousands)	Pass/Performing	Special Mention	Substandard	Doubtful	Total
December 31, 2016					
Construction	\$ 72,641	\$ 4,195	\$ 7,166	\$ -	\$ 84,002
Residential real estate	312,242	6,646	6,880	-	325,768
Commercial real estate	363,461	10,939	8,281	-	382,681
Commercial	71,313	857	265	-	72,435
Consumer	6,540	-	99	-	6,639
Total	<u>\$ 826,197</u>	<u>\$ 22,637</u>	<u>\$ 22,691</u>	<u>\$ -</u>	<u>\$ 871,525</u>

The following tables provide information on the aging of the loan portfolio as of September 30, 2017 and December 31, 2016.

(Dollars in thousands)	Current	30-59 days past due	Accruing 60-89 days past due	Greater than 90 days	Total past due	Nonaccrual	Total
September 30, 2017							
Construction	\$ 103,606	\$ 58	\$ -	\$ -	\$ 58	\$ 2,953	\$ 106,617
Residential real estate	383,913	572	667	5	1,244	2,565	387,722
Commercial real estate	451,789	2,407	-	-	2,407	430	454,626
Commercial	91,225	202	31	-	233	341	91,799
Consumer	6,478	-	5	-	5	-	6,483
Total	<u>\$ 1,037,011</u>	<u>\$ 3,239</u>	<u>\$ 703</u>	<u>\$ 5</u>	<u>\$ 3,947</u>	<u>\$ 6,289</u>	<u>\$ 1,047,247</u>
Percent of total loans	99.0 %	0.3 %	0.1 %	- %	0.4 %	0.6 %	100.0 %

(Dollars in thousands)	Current	30-59 days past due	Accruing 60-89 days past due	Greater than 90 days	Total past due	Nonaccrual	Total
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	<u>\$ 852,410</u>	<u>\$ 5,029</u>	<u>\$ 5,094</u>	<u>\$ 20</u>	<u>\$ 10,143</u>	<u>\$ 8,972</u>	<u>\$ 871,525</u>
Percent of total loans	97.8 %	0.6 %	0.6 %	- %	1.2 %	1.0 %	100.0 %

Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for the three months and nine months ended September 30, 2017 and 2016. Allocation of a portion of the allowance to one loan class does not preclude its availability to absorb losses in other loan classes.

Management re-evaluated the allowance methodology during the third quarter of 2016, in connection with the consolidation of the two former bank subsidiaries. Prior to consolidation, each bank subsidiary applied a separate allowance methodology based on their respective loan portfolios. The revised methodology incorporates both previous methodologies to align with a consolidated loan portfolio. In addition, beginning in January of 2017, the allowance methodology was expanded to require the allocation of general reserves to pass/watch loans. This change resulted in an increase in allowance for the first quarter of 2017 when compared to the fourth quarter of 2016 of \$1.1 million, which was partially offset by a reduction in specific reserves of \$850 thousand.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For three months ended September 30, 2017							
Allowance for credit losses:							
Beginning Balance	\$ 2,349	\$ 2,096	\$ 2,802	\$ 1,652	\$ 233	\$ -	\$ 9,132
Charge-offs	-	(70)	(100)	(99)	(18)	-	(287)
Recoveries	11	11	8	67	8	-	105
Net charge-offs	11	(59)	(92)	(32)	(10)	-	(182)
Provision	(119)	6	174	184	100	-	345
Ending Balance	\$ 2,241	\$ 2,043	\$ 2,884	\$ 1,804	\$ 323	\$ -	\$ 9,295

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For three months ended September 30, 2016							
Allowance for credit losses:							
Beginning Balance	\$ 1,744	\$ 2,035	\$ 2,871	\$ 677	\$ 206	\$ 825	\$ 8,358
Charge-offs	(9)	(407)	-	(139)	(13)	-	(568)
Recoveries	8	121	10	79	1	-	219
Net charge-offs	(1)	(286)	10	(60)	(12)	-	(349)
Provision	275	331	306	300	(40)	(567)	605
Ending Balance	\$ 2,018	\$ 2,080	\$ 3,187	\$ 917	\$ 154	\$ 258	\$ 8,614

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For nine months ended							
September 30, 2017							
Allowance for credit losses:							
Beginning Balance	\$ 2,787	\$ 1,953	\$ 2,610	\$ 1,145	\$ 231	\$ -	\$ 8,726
Charge-offs	(54)	(393)	(100)	(870)	(33)	-	(1,450)
Recoveries	27	32	27	167	20	-	273
Net charge-offs	(27)	(361)	(73)	(703)	(13)	-	(1,177)
Provision	(519)	451	347	1,362	105	-	1,746
Ending Balance	<u>\$ 2,241</u>	<u>\$ 2,043</u>	<u>\$ 2,884</u>	<u>\$ 1,804</u>	<u>\$ 323</u>	<u>\$ -</u>	<u>\$ 9,295</u>

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
For nine months ended							
September 30, 2016							
Allowance for credit losses:							
Beginning Balance	\$ 1,646	\$ 2,181	\$ 2,999	\$ 558	\$ 156	\$ 776	\$ 8,316
Charge-offs	(263)	(525)	(503)	(264)	(23)	-	(1,578)
Recoveries	24	188	20	201	13	-	446
Net charge-offs	(239)	(337)	(483)	(63)	(10)	-	(1,132)
Provision	611	236	671	422	8	(518)	1,430
Ending Balance	<u>\$ 2,018</u>	<u>\$ 2,080</u>	<u>\$ 3,187</u>	<u>\$ 917</u>	<u>\$ 154</u>	<u>\$ 258</u>	<u>\$ 8,614</u>

Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that were in the process of foreclosure totaled \$620 thousand and \$ 687 thousand as of September 30, 2017 and December 31, 2016, respectively. At September 30, 2017, there were 2 residential properties held in other real estate owned totaling \$0 , compared to 3 residential properties totaling \$92 thousand at December 31, 2016 .

All TDRs were in compliance with their modified terms and there are no further commitments associated with these loans as of September 30, 2017 and December 31, 2016 .

Note 6 – Goodwill and Other Intangibles

On May 19, 2017, the Bank acquired three branches located in Arbutus, Owings Mills and Elkridge, Maryland from NWBI. The purchase of these branches resulted in core deposit intangibles of \$4.0 million and goodwill of \$15.3 million.

The gross carrying amount and accumulated amortization of intangible assets is as follows:

September 30, 2017					
(Dollars in thousands)	Gross Carrying Amount	Accumulated Impairment Charges	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (in years)
Goodwill	\$ 31,213	\$ (2,637)	\$ (667)	\$ 27,909	-
Other intangible assets					
Amortizable					
Employment agreements	\$ 440	\$ -	\$ (440)	\$ -	-
Insurance expirations	1,270	-	(1,268)	2	0.0
Customer relationships	795	(95)	(473)	227	4.9
Core deposit intangible	3,954	-	(132)	3,822	9.7
	6,459	(95)	(2,313)	4,051	
Unamortizable					
Trade name	780	-	-	780	-
Total other intangible assets	\$ 7,239	\$ (95)	\$ (2,313)	\$ 4,831	
December 31, 2016					
(Dollars in thousands)	Gross Carrying Amount	Accumulated Impairment Charges	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (in years)
Goodwill	\$ 15,235	\$ (2,637)	\$ (667)	\$ 11,931	-
Other intangible assets					
Amortizable					
Employment agreements	\$ 440	\$ -	\$ (440)	\$ -	-
Insurance expirations	1,270	-	(1,233)	37	0.4
Customer relationships	795	(95)	(438)	262	5.6
	2,505	(95)	(2,111)	299	
Unamortizable					
Trade name	780	-	-	780	-
Total other intangible assets	\$ 3,285	\$ (95)	\$ (2,111)	\$ 1,079	

At September 31, 2017, estimated future remaining amortization for amortizing intangibles within the years ending December 31, was as follows:

(Dollars in thousands)

2017	\$	282
2018		442
2019		442
2020		395
2021		439
Thereafter		2,051
Total amortizing intangible assets	\$	4,051

Note 7 – Other Assets

The Company had the following other assets at September 30, 2017 and December 31, 2016.

(Dollars in thousands)	September 30, 2017	December 31, 2016
Nonmarketable investment securities	\$ 3,069	\$ 1,650
Accrued interest receivable	3,122	2,675
Deferred income taxes, net	2,628	7,040
Prepaid expenses	1,528	1,148
Cash surrender value on life insurance	671	2,589
Other assets	5,937	3,781
Total	\$ 16,955	\$ 18,883

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of September 30, 2017 and December 31, 2016.

(Dollars in thousands)	September 30, 2017	December 31, 2016
Deferred tax assets:		
Allowance for credit losses	\$ 3,712	\$ 3,486
Reserve for off-balance sheet commitments	121	122
Net operating loss carry forward	842	2,232
Write-downs of other real estate owned	310	387
Deferred income	127	1,011
Unrealized losses on available-for-sale securities	4	672
Unrealized losses on available-for-sale securities transferred to held to maturity	33	-
AMT Credits	-	869
Amortization on loans FMV adjustment	194	-
Other	982	1,192
Total deferred tax assets	<u>6,325</u>	<u>9,971</u>
Deferred tax liabilities:		
Depreciation	159	239
Amortization on loans FMV adjustment	-	156
Purchase accounting adjustments	2,927	2,019
Deferred capital gain on branch sale	347	401
Other	264	116
Total deferred tax liabilities	<u>3,697</u>	<u>2,931</u>
Net deferred tax assets	<u>\$ 2,628</u>	<u>\$ 7,040</u>

The Company's deferred tax assets consist of gross net operating loss carryovers for state tax purposes of \$15.7 million that will be used to offset taxable income in future periods. The Company's state net operating loss carryovers will begin to expire in the year ended December 31, 2026 with limited amounts available through December 31, 2034 .

No valuation allowance on these deferred tax assets was recorded at September 30, 2017 and December 31, 2016 as management believes it is more likely than not that all deferred tax assets will be realized .

Note 8 – Other Liabilities

The Company had the following other liabilities at September 30, 2017 and December 31, 2016.

(Dollars in thousands)	September 30, 2017		December 31, 2016	
Accrued interest payable	\$	59	\$	74
Other accounts payable		4,146		2,461
Deferred compensation liability		1,197		1,444
Other liabilities		413		1,301
Total	\$	5,815	\$	5,280

Note 9 - Stock-Based Compensation

At the 2016 annual meeting, stockholders approved the Shore Bancshares, Inc. 2016 Stock and Incentive Plan (“2016 Equity Plan”), replacing the Shore Bancshares, Inc. 2006 Stock and Incentive Plan (“2006 Equity Plan”), which expired on that date. The Company may issue shares of common stock or grant other equity-based awards pursuant to the 2016 Equity Plan. Stock-based awards granted to date generally are time-based, vest in equal installments on each anniversary of the grant date and range over a one- to five-year period of time, and, in the case of stock options, expire 10 years from the grant date. As part of the 2016 Equity Plan, a performance equity incentive award program, known as the “Long-term incentive plan” allows participating officers of the Company to earn incentive awards of performance share/restricted stock units if certain pre-determined targets are achieved at the end of a three-year performance cycle. Stock-based compensation expense based on the grant date fair value is recognized ratably over the requisite service period for all awards and reflects forfeitures as they occur. The 2016 Equity Plan originally reserved 750,000 shares of common stock for grant, and 709,873 shares remained available for grant at September 30, 2017.

The following tables provide information on stock-based compensation expense for the three and nine months ended September 30, 2017 and 2016.

(Dollars in thousands)	For Three Months Ended September 30,		For Nine Months Ended September 30,	
	2017	2016	2017	2016
Stock-based compensation expense	\$ 158	\$ 85	\$ 748	\$ 262
Excess tax benefits related to stock-based compensation	15	12	26	25

(Dollars in thousands)	September 30,	
	2017	2016
Unrecognized stock-based compensation expense	\$ 1,147	\$ 132
Weighted average period unrecognized expense is expected to be recognized	1.3 years	0.6 years

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2017 and 2016.

	Nine Months Ended September 30, 2017	
	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	17,066	\$ 11.46
Granted	21,470	16.69
Vested	(22,623)	13.66
Cancelled	-	-
Nonvested at end of period	15,913	\$ 12.49

The fair value of restricted stock awards that vested during the first nine months of 2017 and 2016 was \$309 thousand and \$204 thousand, respectively.

Restricted stock units (RSUs) are similar to restricted stock, except the recipient does not receive the stock immediately, but instead receives it upon the terms and conditions of the Company's long-term incentive plans which are subject to performance milestones achieved at the end of a three-year period. Each RSU cliff vests at the end of the three-year period and entitles the recipient to receive one share of common stock on a specified issuance date. The recipient does not have any stockholder rights, including voting rights, with respect to the shares underlying awarded RSUs until the recipient becomes the holder of those shares.

During 2017, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2019. These awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 12,703 shares and 50,830 shares, assuming a certain performance metric is met. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

During 2016, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on a performance metric to be achieved as of December 31, 2018. These awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 12,214 shares and 48,871 shares, assuming a certain performance metric is met. In addition, two members of the long-term incentive plan from 2015 forfeited their RSUs due to leaving the Company before the end of the vesting period. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

During 2015, the Company entered into a long-term incentive program agreement with officers of the Company and its subsidiaries to award RSUs based on performance metrics to be achieved as of December 31, 2017. These awards will cliff vest on this date, in which the final number of common shares to be issued will be determined. The range of RSUs which could potentially be awarded at the end of the performance cycle is between 10,953 shares and 43,821 shares, assuming certain performance metrics are met. The table below presents management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle.

The following table summarizes restricted stock units activity based on management's evaluation of the probable number of common stock awards to be issued at the end of the performance cycle for the Company under the 2016 and 2006 Equity Plans for the nine months ended September 30, 2017 and 2016.

	Nine Months Ended September 30, 2017	
	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of period	46,342	\$ 10.64
Granted	25,410	16.57
Vested	-	-
Forfeited	-	-
Outstanding at end of period	71,752	\$ 12.01

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the nine months ended September 30, 2017 and 2016.

	Nine Months Ended September 30, 2017	
	Number of Shares	Weighted Average Grant Date Exercise Price
Outstanding at beginning of period	62,086	\$ 8.29
Granted	1,202	10.99
Exercised	(859)	6.64
Expired/Cancelled	-	-
Outstanding at end of period	62,429	\$ 8.36
Exercisable at end of period	61,828	\$ 8.34

The weighted average fair value of stock options granted during the nine months ended September 30, 2017 and September 30, 2016 was \$10.99 and \$5.03, respectively. The Company estimates the fair value of options using the Black-Scholes valuation model with weighted average assumptions for dividend yield, expected volatility, risk-free interest rate and expected lives (in years). The expected dividend yield is calculated by dividing the total expected annual dividend payout by the average stock price. The expected volatility is based on historical volatility of the underlying securities. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at grant date. The expected contract life of the options represents the period of time that the Company expects the awards to be outstanding based on historical experience with similar awards. The following weighted average assumptions were used as inputs to the Black-Scholes valuation model for options granted in 2017 and 2016.

	2017	2016
Dividend yield	0.84 %	0.73 %
Expected volatility	64.80 %	38.60 %
Risk-free interest rate	2.42 %	1.75 %
Expected contract life (in years)	10 years	10 years

At the end of the third quarter of 2017, the aggregate intrinsic value of the options outstanding under the 2016 Equity Plan was \$517 thousand based on the \$16.65 market value per share of the Company's common stock at September 30, 2017. Similarly, the aggregate intrinsic value of the options exercisable was \$514 thousand at September 30, 2017. The intrinsic value on options exercised during the nine months ended September 30, 2017 was \$8 thousand based on the \$15.89 market value per share of the Company's common stock at January 30, 2017. The intrinsic value on options exercised in 2016 was \$2 thousand based on the \$11.35 market value per share of the Company's common stock at February 8, 2016. At September 30, 2017, the weighted average remaining contract life of options outstanding was 6.4 years.

Note 10 – Accumulated Other Comprehensive Income

The Company records unrealized holding gains (losses), net of tax, on investment securities available for sale as accumulated other comprehensive income (loss), a separate component of stockholders' equity. The following table provides information on the changes in the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2017 and 2016.

(Dollars in thousands)	Unrealized gains (losses) on available for sale securities	Unrealized gains (losses) on securities transferred from Available-for-sale to Held-to-maturity	Accumulated other comprehensive income (loss)
Balance, December 31, 2016	\$ (931)	\$ (62)	\$ (993)
Other comprehensive income	927	15	942
Reclassification of (gains) recognized	(3)	-	(3)
Balance, September 30, 2017	\$ (7)	\$ (47)	\$ (54)
Balance, December 31, 2015	\$ (71)	\$ -	\$ (71)
Other comprehensive income	1,566	-	1,566
Reclassification of (gains) recognized	(18)	-	(18)
Balances, September 30, 2016	\$ 1,477	\$ -	\$ 1,477

Note 11 – Fair Value Measurements

Accounting guidance under GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. This accounting guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as impaired loans, loans held for sale and other real estate owned (foreclosed assets). These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Under fair value accounting guidance, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine their fair values. These hierarchy levels are:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Below is a discussion on the Company's assets measured at fair value on a recurring basis.

Investment Securities Available for Sale

Fair value measurement for investment securities available for sale is based on quoted prices from an independent pricing service. The fair value measurements consider observable data that may include present value of future cash flows, prepayment assumptions, credit loss assumptions and other factors. The Company classifies its investments in U.S. Treasury securities, if any, as Level 1 in the fair value hierarchy, and it classifies its investments in U.S. Government agencies securities and mortgage-backed securities issued or guaranteed by U.S. Government sponsored entities as Level 2.

The tables below present the recorded amount of assets measured at fair value on a recurring basis at September 30, 2017 and December 31, 2016. No assets were transferred from one hierarchy level to another during the first nine months of 2017 or 2016.

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2017				
Securities available for sale:				
U.S. Government agencies	\$ 52,003	\$ -	\$ 52,003	\$ -
Mortgage-backed	160,725	-	160,725	-
Equity	662	-	662	-
Total	<u>\$ 213,390</u>	<u>\$ -</u>	<u>\$ 213,390</u>	<u>\$ -</u>

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2016				
Securities available for sale:				
U.S. Government agencies	\$ 34,318	\$ -	\$ 34,318	\$ -
Mortgage-backed	128,944	-	128,944	-
Equity	640	-	640	-
Total	<u>\$ 163,902</u>	<u>\$ -</u>	<u>\$ 163,902</u>	<u>\$ -</u>

Below is a discussion on the Company's assets measured at fair value on a nonrecurring basis.

Impaired Loans

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan impairment is measured using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less selling costs) if the loans are collateral dependent and these are considered Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of business equipment, inventory and accounts receivable, discounted on management's review and analysis. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and the client's business. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the factors identified above. Valuation techniques are consistent with those techniques applied in prior periods.

Other Real Estate Owned (Foreclosed Assets)

Foreclosed assets are adjusted for fair value upon transfer of loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value and fair value. The estimated fair value for foreclosed assets included in Level 3 are determined by independent market based appraisals and other available market information, less costs to sell, that may be reduced further based on market expectations or an executed sales agreement. If the fair value of the collateral deteriorates subsequent to the initial recognition, the Company records the foreclosed asset as a non-recurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.

The tables below present the recorded amount of assets measured at fair value on a nonrecurring basis at September 30, 2017 and December 31, 2016.

(Dollars in thousands)	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value	Valuation Technique	Unobservable Input	Range	
September 30, 2017					
Nonrecurring measurements:					
Impaired loans	\$ 6,190	Appraisal of collateral	1	Appraisal adjustments	2 20% - 30%
				Liquidation expense	2 5% - 10%
Other real estate owned	\$ 1,809	Appraisal of collateral	1	Appraisal adjustments	2 20% - 30%
				Liquidation expense	2 5% - 10%

(Dollars in thousands)	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value	Valuation Technique	Unobservable Input	Range	
December 31, 2016					
Nonrecurring measurements:					
Impaired loans	\$ 8,935	Appraisal of collateral	1	Appraisal adjustments	2 20% - 30%
				Liquidation expense	2 5% - 10%
Other real estate owned	\$ 2,477	Appraisal of collateral	1	Appraisal adjustments	2 20% - 30%
				Liquidation expense	2 5% - 10%

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various level III inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

The following information relates to the estimated fair values of financial assets and liabilities that are reported in the Company's consolidated balance sheets at their carrying amounts. The discussion below describes the methods and assumptions used to estimate the fair value of each class of financial asset and liability for which it is practicable to estimate that value.

Cash and Cash Equivalents

Cash equivalents include interest-bearing deposits with other banks and federal funds sold. For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

Investment Securities Held to Maturity

For all investments in debt securities, fair values are based on quoted prices. If a quoted price is not available, fair value is estimated using quoted prices for similar securities.

Loans

The fair values of categories of fixed rate loans, such as commercial loans, residential real estate, and other consumer loans, are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Other loans, including variable rate loans, are adjusted for differences in loan characteristics.

Restricted Securities

The restricted security category is comprised of FHLB and Federal Reserve Bank stock. These stocks are classified as restricted securities because their ownership is restricted to certain types of entities and they lack a market. When the FHLB or Federal Reserve Bank repurchases stock, they repurchase at the stock's book value. Therefore, the carrying amounts of restricted securities approximate fair value.

Bank Owned Life Insurance

The carrying value of bank owned life insurance approximates fair value. The Company records these policies at their cash surrender value, which is estimated using information provided by insurance carriers.

Deposits and Short-Term Borrowings

The fair values of demand deposits, savings accounts, and certain money market deposits are the amounts payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. These estimates do not take into consideration the value of core deposit intangibles. Generally, the carrying amount of short-term borrowings is a reasonable estimate of fair value. The fair values of securities sold under agreements to repurchase (included in short-term borrowings) and long-term debt are estimated using the rates offered for similar borrowings.

Commitments to Extend Credit and Standby Letters of Credit

The majority of the Company's commitments to grant loans and standby letters of credit are written to carry current market interest rates if converted to loans. In general, commitments to extend credit and letters of credit are not assignable by the Company or the borrower, so they generally have value only to the Company and the borrower. Therefore, it is impractical to assign any value to these commitments.

The following table provides information on the estimated fair values of the Company's financial assets and liabilities that are reported in the balance sheets at their carrying amounts. The financial assets and liabilities have been segregated by their classification level in the fair value hierarchy.

(Dollars in thousands)	September 30, 2017		December 31, 2016	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets				
Level 1 inputs				
Cash and cash equivalents	\$ 43,916	\$ 43,916	\$ 75,938	\$ 75,938
Level 2 inputs				
Investment securities held to maturity	\$ 6,241	\$ 6,451	\$ 6,704	\$ 6,806
Restricted securities	3,069	3,069	1,650	1,650
Bank owned life insurance	107	107	105	105
Level 3 inputs				
Loans, net	1,037,952	1,036,002	862,799	867,594
Financial liabilities				
Level 2 inputs				
Deposits:				
Noninterest-bearing demand	\$ 326,020	\$ 326,020	\$ 261,575	\$ 261,575
Checking plus interest	227,973	227,973	203,724	203,724
Money market	221,589	221,589	181,871	181,871
Savings	154,180	154,180	90,051	90,051
Club	1,565	1,565	393	393
Certificates of deposit, \$100,000 or more	113,618	112,271	120,602	119,914
Other time	161,250	158,320	139,273	135,940
Short-term borrowings	1,469	1,469	3,203	3,203

Note 12 – Financial Instruments with Off-Balance Sheet Risk

In the normal course of business, to meet the financial needs of its customers, the Bank is a party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit and other commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the letters of credit and commitments are expected to expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements.

The following table provides information on commitments outstanding at September 30, 2017 and December 31, 2016.

(Dollars in thousands)	September 30, 2017	December 31, 2016
Commitments to extend credit	\$ 220,271	\$ 178,233
Letters of credit	8,335	8,024
Total	\$ 228,606	\$ 186,257

Note 13 – Segment Reporting

The Company operates two primary business segments: Community Banking and Insurance Products and Services. Through the Community Banking business, the Company provides services to consumers and small businesses in Maryland, Delaware and Virginia through its 21 branch network and 2 loan production offices. Community banking activities include small business services, retail brokerage, trust services and consumer banking products and services. Loan products available to consumers include mortgage, home equity, automobile, marine, and installment loans, credit cards and other secured and unsecured personal lines of credit. Small business lending includes commercial mortgages, real estate development loans, equipment and operating loans, as well as secured and unsecured lines of credit, credit cards, accounts receivable financing arrangements, and merchant card services.

Through the Insurance Products and Services business, the Company provides a full range of insurance products and services to businesses and consumers in the Company's market areas. Products include property and casualty, life, marine, individual health and long-term care insurance. Pension and profit sharing plans and retirement plans for executives and employees are available to suit the needs of individual businesses.

The following table includes selected financial information by business segments for the first nine months of 2017 and 2016.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2017				
Interest Income	\$ 34,761	\$ (1)	\$ 73	\$ 34,833
Interest Expense	(1,674)	-	-	(1,674)
Provision for credit losses	(1,746)	-	-	(1,746)
Noninterest income	6,111	7,300	-	13,411
Noninterest expense	(18,651)	(6,035)	(5,884)	(30,570)
Net intersegment (expense) income	(5,500)	(84)	5,584	-
Income (loss) before taxes	13,301	1,180	(227)	14,254
Income tax (expense) benefit	(5,309)	(472)	91	(5,690)
Net Income (loss)	\$ 7,992	\$ 708	\$ (136)	\$ 8,564
Total assets, September 30, 2017	\$ 1,359,930	\$ 9,909	\$ 6,289	\$ 1,376,127
2016				
Interest Income	\$ 29,957	\$ -	\$ 190	\$ 30,147
Interest Expense	(1,863)	-	-	(1,863)
Provision for credit losses	(1,430)	-	-	(1,430)
Noninterest income	5,749	6,840	-	12,589
Noninterest expense	(15,874)	(5,205)	(6,842)	(27,921)
Net intersegment (expense) income	(6,027)	(566)	6,593	-
Income (loss) before taxes	10,512	1,069	(59)	11,522
Income tax (expense) benefit	(3,973)	(424)	18	(4,379)
Net Income (loss)	\$ 6,539	\$ 645	\$ (41)	\$ 7,143
Total assets, September 30, 2016	\$ 1,129,427	\$ 9,647	\$ 18,792	\$ 1,157,866

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Unless the context clearly suggests otherwise, references to "the Company", "we", "our", and "us" in the remainder of this report are to Shore Bancshares, Inc. and its consolidated subsidiaries.

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions about our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission (the "SEC") entitled "Risk Factors" (see Item 1A of Part II of this report and Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2016 (the "2016 Annual Report")). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

The following discussion and analysis is intended as a review of significant factors affecting the Company's financial condition and results of operations for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and related notes presented elsewhere in this report, as well as the audited consolidated financial statements and related notes included in the 2016 Annual Report.

Shore Bancshares, Inc. is the largest independent financial holding company headquartered on the Eastern Shore of Maryland. It is the parent company of Shore United Bank. The Bank operates 21 full service branches in Baltimore County, Howard County, Kent County, Queen Anne's County, Talbot County, Caroline County and Dorchester County in Maryland, Kent County, Delaware and Accomack County, 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.

The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Select Market under the symbol "SHBI".

Shore Bancshares, Inc. maintains an Internet site at www.shorebancshares.com on which it makes available free of charge its Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to the foregoing as soon as reasonably practicable after these reports are electronically filed with, or furnished to, the SEC.

Critical Accounting Policies

Our financial statements are prepared in accordance with GAAP. The financial information contained within the financial statements is, to a significant extent, financial information that is based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions, and estimates underlying those amounts, management has determined that the accounting policies with respect to the allowance for credit losses, goodwill and other intangible assets, deferred tax assets, and fair value are critical accounting policies. These policies are considered critical because they relate to accounting areas that require the most subjective or complex judgments, and, as such, could be most subject to revision as new information becomes available.

Allowance for Credit Losses

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 formula allowance; and (iii) the unallocated 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 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. Loans identified as special mention, substandard, and doubtful are adversely rated. 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 unallocated allowance captures losses that have impacted the portfolio but have yet to be recognized in either the specific or formula allowance.

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.

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 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.

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. 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.

OVERVIEW

The Company reported net income of \$3.4 million for the third quarter of 2017, or diluted income per common share of \$0.27, compared to net income of \$2.4 million, or diluted income per common share of \$0.19, for the third quarter of 2016. For the second quarter of 2017, the Company reported net income of \$2.4 million, or diluted income per common share of \$0.19. When comparing the third quarter of 2017 to the third quarter of 2016, the primary reasons for improved net income were increases in net interest income of \$2.7 million, noninterest income of \$418 thousand and a reduction in provision for credit losses of \$260 thousand, partially offset by an increase in noninterest expenses of \$1.5 million. When comparing the third quarter of 2017 to the second quarter of 2017, the higher net income was primarily attributable to increases in net interest income of \$1.4 million, noninterest income of \$246 thousand, and a reduction in provision for credit losses of \$629 thousand, partially offset by an increase in noninterest expenses of \$521 thousand. These increases were a direct result of operating the three branches acquired from NWBI for a full quarter. The reduction in provision for credit losses was due to a large charge-off in the second quarter of 2017 which was the result of one borrowing relationship.

For the first nine months of 2017, the Company reported net income of \$8.6 million, or diluted income per common share of \$0.67, compared to net income of \$7.1 million, or diluted income per common share of \$0.56, for the first nine months of 2016. Earnings improved due to increases in net interest income of \$4.9 million and noninterest income of \$822 thousand, partially offset by increases in provision for credit losses of \$316 thousand and noninterest expenses of \$2.6 million, of which \$977 thousand related to acquisition costs from the branch purchase.

RESULTS OF OPERATIONS

Net Interest Income

Tax-equivalent net interest income is net interest income adjusted for the tax-favored status of income from certain loans and investments. As shown in the table below, tax-equivalent net interest income was \$12.4 million for the third quarter of 2017 and \$9.7 million for the third quarter of 2016. Tax-equivalent net interest income was \$11.0 million for the second quarter of 2017. The increase in net interest income for the third quarter of 2017 when compared to the third quarter of 2016 was primarily due to an increase in interest income of \$2.7 million, or 26.1%, partially offset by an increase in interest expense of \$33 thousand, or 6.1%. The increase in net interest income compared to the second quarter of 2017 was primarily due to an increase in interest income of \$1.5 million, or 12.9%, partially offset by an increase in interest expense of \$62 thousand, or 11.3%. Net interest margin is tax-equivalent net interest income (annualized) divided by average earning assets. The net interest margin increased in the third quarter of 2017 to 3.79% when compared to both the third quarter of 2016 and the second quarter of 2017 of 3.54% and 3.73%, respectively.

Interest Income

On a tax-equivalent basis, interest income increased \$2.7 million, or 26.1%, for the third quarter of 2017 when compared to the third quarter of 2016. The increase was primarily due to a \$2.4 million, or 24.9%, increase in interest income and fees on loans. This increase was due to a \$197.6 million, or 23.6% increase in the average balance of loans which primarily resulted from the purchase of \$122.9 million in loans from NWBI in the second quarter of 2017 and organic loan growth of \$70.2 million. The average yield on loans increased 4 bps, which increased from 4.50% to 4.54%, primarily due to the higher yielding loan portfolio acquired from NWBI relative to the Bank's legacy portfolio. In addition, interest and dividends on taxable investment securities increased \$280 thousand, or 37.1%, during the third quarter of 2017 compared to the same period last year, primarily the result of a \$28.4 million, or 14.9% increase in the average balance of taxable investment securities which was partially funded by the excess cash received from the branch purchase.

On a tax-equivalent basis, interest income increased \$1.5 million, or 12.9%, for the third quarter of 2017 when compared to the second quarter of 2017. The increase was primarily due to a \$1.3 million, or 12.7%, increase in interest income and fees on loans. This increase was due to a \$81.5 million, or 8.6% increase in the average balance of loans due to the full quarter impact of the loans acquired from NWBI. The average yield on loans increased 12 bps, which increased from 4.42% to 4.54%. In addition, interest and dividends on taxable investment securities increased \$97 thousand, or 104%, during the third quarter of 2017 compared to the linked quarter, primarily the result of a \$20.5 million, or 10.4% increase in the average balance of taxable investment securities.

Interest Expense

Interest expense increased \$33 thousand, or 5.7%, when comparing the third quarter of 2017 to the third quarter of 2016. The increase in interest expense was due to an increase in the average balance of total interest-bearing deposits of \$150.5 million, or 20.3%, primarily the result of the acquisition of interest-bearing deposits from NWBI amounting to \$177.9 million in the second quarter of 2017, which had a balance of \$186.0 million at September 30, 2017. Despite the significant increase in average interest-bearing deposits, the rates paid on these deposits declined 4 bps. The average balance on noninterest-bearing deposits increased \$75.4 million, or 30.8%, and the average balance on short-term borrowings decreased \$4.8 million, or 67.9%, all of which resulted in a lower cost of funding for the third quarter of 2017 when compared to the third quarter of 2016.

Interest expense increased \$62 thousand, or 11.3%, when comparing the third quarter of 2017 to the second quarter of 2017. The increase in interest expense was due to an increase in the average balance of total interest-bearing deposits of \$98.4 million, or 12.4%, primarily the result of a full quarter impact of the deposits acquired from NWBI, while the average rate paid on interest-bearing deposits remained unchanged. Interest expense on short-term borrowings declined \$7 thousand, or 63.6% which contributed to a 1bp decline in the overall cost of funds when comparing the third quarter 2017 to the second quarter 2017.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the three months ended September 30, 2017 and 2016.

(Dollars in thousands)	For Three Months Ended September 30, 2017			For Three Months Ended September 30, 2016		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	\$ 1,034,553	\$ 11,830	4.54 %	\$ 836,955	\$ 9,469	4.50 %
Investment securities:						
Taxable	218,675	1,035	1.89	190,265	754	1.59
Tax-exempt	-	-	-	210	3	5.30
Federal funds sold	-	-	-	511	1	0.37
Interest-bearing deposits	42,204	131	1.23	64,164	81	0.50
Total earning assets	1,295,432	12,996	3.98 %	1,092,105	10,308	3.75 %
Cash and due from banks	16,232			15,678		
Other assets	75,611			52,836		
Allowance for credit losses	(9,300)			(8,310)		
Total assets	\$ 1,377,975			\$ 1,152,309		
Interest-bearing liabilities						
Demand deposits	\$ 224,180	132	0.23 %	\$ 199,116	58	0.12 %
Money market and savings deposits	378,711	113	0.12	268,183	86	0.13
Certificates of deposit \$100,000 or more	123,538	154	0.50	125,265	192	0.61
Other time deposits	164,459	208	0.50	147,780	238	0.64
Interest-bearing deposits	890,888	607	0.27	740,344	574	0.31
Short-term borrowings	2,274	4	0.62	7,075	4	0.25
Total interest-bearing liabilities	893,162	611	0.27 %	747,419	578	0.31 %
Noninterest-bearing deposits	320,006			244,596		
Other liabilities	5,256			6,309		
Stockholders' equity	159,551			153,985		
Total liabilities and stockholders' equity	\$ 1,377,975			\$ 1,152,309		
Net interest spread		\$ 12,385	3.71 %		\$ 9,730	3.44 %
Net interest margin			3.79 %			3.54 %
Tax-equivalent adjustment						
Loans		\$ 59			\$ 72	
Investment securities		-			1	
Total		\$ 59			\$ 73	

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 35.0%, exclusive of the alternative minimum tax rate and

nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Net Interest Income

Tax-equivalent net interest income increased \$4.9 million, or 17.3%, during the nine months ended September 30, 2017 compared to the nine months ended September 30, 2016. The increase in net interest income was primarily due to an increase in interest income of \$4.7 million, or 15.6% and a decrease in interest expense of \$18.9 thousand, or 10.1%. These positive variances, resulted in an improved net interest margin of 3.75% for the nine months ended September 30, 2017 compared to 3.54% for the nine months ended September 30, 2016.

Interest Income

On a tax-equivalent basis, interest income increased \$4.7 million, or 15.6%, for the nine months ended September 30, 2017 when compared to the nine months ended September 30, 2016. The increase was primarily due to a \$4.3 million, or 15.7%, increase in interest income and fees on loans. This increase was due to a \$144.9 million, or 17.9% increase in the average balance of loans resulting from the purchase of \$122.9 million

in loans from NWBI in the second quarter of 2017 and organic loan growth of \$59.2 million. The average yield on loans declined 8 bps, which decreased from 4.54% to 4.46%. In addition, interest and dividends on taxable investment securities increased \$350 thousand, or 14.3%, during the first nine months of 2017 compared to the same period last year, primarily the result of higher average yields on taxable investment securities of 27bps.

Interest Expense

Interest expense decreased \$18.9 thousand, or 10.1%, when comparing the nine months ended September 30, 2017 to the nine months ended September 30, 2016. The decrease in interest expense was due to decreases in the average rate paid on interest-bearing deposits of 6bps and the average balance in short-term borrowings of \$2.4 million, or 37.3%. The average balance of total interest-bearing deposits increased \$68.7 million, or 9.3% when comparing the first nine months of 2017 to the first nine months of 2016, primarily the result of the acquisition of deposits from NWBI of \$212.5 million in the second quarter of 2017.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid for the nine months ended September 30, 2017 and 2016.

(Dollars in thousands)	For Nine Months Ended September 30, 2017			For Nine Months Ended September 30, 2016		
	Average Balance	Income(1)/ Expense	Yield/ Rate	Average Balance	Income(1)/ Expense	Yield/ Rate
Earning assets						
Loans (2), (3)	\$ 956,694	\$ 31,941	4.46 %	\$ 811,747	\$ 27,608	4.54 %
Investment securities:						
Taxable	198,383	2,799	1.88	203,016	2,448	1.61
Tax-exempt	116	5	5.41	210	8	5.30
Federal funds sold	-	-	-	2,347	6	0.34
Interest-bearing deposits	34,506	269	1.04	55,837	211	0.50
Total earning assets	1,189,699	35,014	3.93 %	1,073,157	30,281	3.77 %
Cash and due from banks	14,988			15,554		
Other assets	61,537			54,850		
Allowance for credit losses	(9,072)			(8,459)		
Total assets	\$ 1,257,152			\$ 1,135,102		
Interest-bearing liabilities						
Demand deposits	\$ 206,033	279	0.18 %	\$ 192,803	173	0.12 %
Money market and savings deposits	325,660	300	0.12	262,818	258	0.13
Certificates of deposit \$100,000 or more	121,508	467	0.51	129,060	647	0.67
Other time deposits	151,179	610	0.54	151,032	774	0.68
Interest-bearing deposits	804,380	1,656	0.28	735,713	1,852	0.34
Short-term borrowings	3,997	18	0.59	6,372	11	0.24
Total interest-bearing liabilities	808,377	1,674	0.28 %	742,085	1,863	0.34 %
Noninterest-bearing deposits	285,324			235,448		
Other liabilities	5,109			6,131		
Stockholders' equity	158,342			151,438		
Total liabilities and stockholders' equity	\$ 1,257,152			\$ 1,135,102		
Net interest spread		\$ 33,340	3.65 %		\$ 28,418	3.43 %
Net interest margin			3.75 %			3.54 %
Tax-equivalent adjustment						
Loans	\$ 179			\$ 132		
Investment securities	2			2		
Total	\$ 181			\$ 134		

(1) All amounts are reported on a tax-equivalent basis computed using the statutory federal income tax rate of 35.0%, exclusive of the alternative minimum tax rate and

nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

(3) Interest income on loans includes amortized loan fees, net of costs, and all are included in the yield calculations.

Noninterest Income

Total noninterest income for the third quarter of 2017 increased \$ 418 thousand , or 10.4 % , when compared to the third quarter of 2016 . The increase from the third quarter of 2016 was due to higher service charges and fees on deposit accounts, higher trust and investment income, higher insurance agency commissions and a positive result on an insurance agency investment recorded in other income , partially offset by higher recognized gains on investment securities in the third quarter of 2016. Noninterest income increased \$246 thousand, or 5.9% when compared to the second quarter of 2017 mainly due to service charges on deposit accounts for a full quarter on the deposits acquired in the branch purchase, higher insurance agency commissions and an increase on an insurance agency investment included in other noninterest income.

Total noninterest income for the nine months ended September 30, 2017 increased \$822 thousand, or 6.5%, when compared to the same period in 2016 . The increase was primarily due to increases in insurance agency commissions of \$185 thousand and other noninterest income of \$538 thousand which included higher fees on bank services of \$241 thousand and positive earnings from an insurance investment of \$274 thousand.

Noninterest Expense

Total noninterest expense for the third quarter of 2017 increased \$1.5 million, or 16.3%, when compared to the third quarter of 2016. The increase in noninterest expenses for the third quarter of 2017 compared to the third quarter of 2016 was primarily due to operating three additional branches, acquisition costs and increases in employee benefits due to the higher insurance premiums paid for group insurance and higher salaries and wages due to pay increases implemented in the first quarter of 2017. Total noninterest expenses increased \$521 thousand, or 5.1%, when compared to the second quarter of 2017 . The increase was primarily due to a full quarter of operating three additional branches acquired in the second quarter of 2017. The branch purchase resulted in increases in salary and wages, employee benefits, and FDIC insurance premium expense, which were partially offset by lower legal and professional fees which were elevated in the second quarter due to the acquisition.

Total noninterest expense for the nine months ended September 30, 2017 increased \$2.6 million, or 9.5%, when compared to the same period in 2016. The increase was primarily due to the branch purchase in the second quarter of 2017 which resulted in acquisition costs of \$977 thousand and the cost of operating those branches for four months. In addition, higher salaries/wages and employee benefits resulted in increased non-interest expenses which were partially offset by a decrease in FDIC insurance premiums.

Provision for Credit Losses

The provision for credit losses was \$345 thousand for the third quarter of 2017, \$605 thousand for the third quarter of 2016 and \$974 thousand for the second quarter of 2017. The lower level of provision for credit losses when comparing the third quarter of 2017 to both the third quarter of 2016 and the second quarter of 2017 was driven by lower charge-offs and improved credit quality. The provision for credit losses for the nine months ended September 30, 2017 and 2016 was \$1.7 million and \$1.4 million, respectively, while net charge-offs were \$1.2 million and \$1.1 million, respectively. The increase in provision for credit losses primarily occurred in the second quarter of 2017 due to the partial charge-off of a negotiated restructured commercial loan. The ratio of annualized net charge-offs to average loans was 0.16% for the first nine months of September 30, 2017 and 0.19% for the same period in 2016.

Income Taxes

For the third quarter of 2017 and 2016, the Company reported income tax expense of \$2.3 million and \$1.4 million, respectively, while the effective tax rate was 40.0% and 37.3%, respectively. The increase in tax rates for the third quarter of 2017 when compared to the same period in 2016 was due to higher pretax income. Income taxes for the nine months ended September 30, 2017 increased \$1.3 million, or 29.9%, when compared to the same period in 2016. The increase was primarily due higher taxable income of \$2.7 million which increased tax rates from 38.0% in the prior period to 39.9% for the 2017 period.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans totaled \$1.0 billion at September 30, 2017 and \$871.5 million at December 31, 2016, an increase of \$175.5 million, or 20.2%. The significant increase was primarily due to loans acquired from NWBI of \$122.9 million, which had a balance of \$116.5 million at September 30, 2017. Excluding the loans acquired from NWBI , total loans increased \$58.8 million, or 6.7 % . The most significant categories which increased organically were construction of \$18.8 million, residential real estate of \$18.6 million and commercial of \$18.6 million. Loans included deferred costs, net of deferred fees, of \$632 thousand and discounts on acquired loans of \$2.0 million at September 30, 2017. Loans included deferred costs, net of deferred fees, of \$509 thousand at December 31, 2016. We do not engage in foreign or subprime lending activities. See Note 4, "Loans and Allowance for Credit Losses", in the Notes to Consolidated Financial Statements and below under the caption "Allowance for Credit Losses" for additional information.

Our loan portfolio has a commercial real estate loan concentration, which is defined as a combination of construction and commercial real estate loans. Construction loans were \$106.6 million, or 10.2% of total loans, at September 30, 2017, higher than the \$84.0 million, or 9.6% of total loans at December 31, 2016. Commercial real estate loans were \$454.6 million, or 43.4% of total loans, at September 30, 2017, compared to \$382.7 million, or 43.9% of total loans at December 31, 2016.

The federal banking regulators have issued guidance for those institutions which are deemed to have concentrations in commercial real estate lending. Pursuant to the supervisory criteria contained in the guidance for identifying institutions with a potential commercial real estate concentration risk, institutions which have (1) total reported loans for construction, land development, and other land acquisitions which represent

100% or more of an institution's total risk-based capital; or (2) total commercial real estate loans representing 300% or more of the institution's total risk-based capital and the institution's commercial real estate loan portfolio has increased 50% or more during the prior 36 months are identified as having potential commercial real estate concentration risk. Institutions which are deemed to have concentrations in commercial real estate lending are expected to employ heightened levels of risk management with respect to their commercial real estate portfolios, and may be required to hold higher levels of capital. The Company, like many community banks, has a concentration in commercial real estate loans, and the Company has experienced significant growth in its commercial real estate portfolio in recent years. At September 30, 2017, non-owner-occupied commercial real estate loans (including construction, land and land development loans) represented 269.9 % of total risk based capital. At such time, construction, land and land development loans represented 79.4% of total risk based capital.

The commercial real estate portfolio has increased 95.3% during the prior 36 months. Management has extensive experience in commercial real estate lending, and has implemented and continues to maintain heightened risk management procedures, and strong underwriting criteria with respect to its commercial real estate portfolio. Monitoring practices include periodic stress testing analysis to evaluate changes to cash flows, owing to interest rate increases and declines in net operating income. We may be required to maintain higher levels of capital as a result of our commercial real estate concentrations, which could require us to obtain additional capital, and may adversely affect shareholder returns.

Allowance for Credit Losses

We have established an allowance for credit losses, which is increased by provisions charged against earnings and recoveries of previously charged-off debts and is decreased by current period charge-offs of uncollectible debts. Management evaluates the adequacy of the allowance for credit losses at least quarterly and adjusts the provision for credit losses based on this analysis. The evaluation of the adequacy of the allowance for credit losses is based primarily on a risk rating system of individual loans, as well as on a collective evaluation of smaller balance homogenous loans, each grouped by loan type. Each loan type is assigned allowance factors based on criteria such as past credit loss experience, local economic and industry trends, and other measures which may impact collectability. Please refer to the discussion above under the caption "Critical Accounting Policies" for an overview of the underlying methodology management employs to maintain the allowance.

Net charge-offs were \$182 thousand for the third quarter of 2017 and \$349 thousand for the third quarter of 2016. Management remains focused on its efforts to dispose of problem loans and to prudently charge-off nonperforming assets to enable the Company to continue to improve its overall credit quality. The allowance for credit losses as a percentage of period-end loans was 0.89% as of September 30, 2017 and 1.00% for both December 31, 2016 and September 30, 2016. The decrease in such ratio at September 30, 2017 was due to the performing loans acquired in the NWBI transaction with no associated allowance since they were recorded at fair value. The allowance for credit losses as a percentage of period-end loans, excluding the acquired loans from NWBI was 1.00% at September 30, 2017. Management believes that the provision for credit losses and the resulting allowance were adequate to provide for probable losses inherent in our loan portfolio at September 30, 2017.

The following table presents a summary of the activity in the allowance for credit losses at or for the three and nine months ended September 30, 2017 and 2016 .

(Dollars in thousands)	At or for Three Months Ended September 30,		At or for Nine Months Ended September 30,	
	2017	2016	2017	2016
Allowance balance - beginning of period	\$ 9,132	\$ 8,358	\$ 8,726	\$ 8,316
Charge-offs:				
Construction	-	(9)	(54)	(263)
Residential real estate	(70)	(407)	(393)	(525)
Commercial real estate	(100)	-	(100)	(503)
Commercial	(99)	(139)	(870)	(264)
Consumer	(18)	(13)	(33)	(23)
Total	(287)	(568)	(1,450)	(1,578)
Recoveries:				
Construction	11	8	27	24
Residential real estate	11	121	32	188
Commercial real estate	8	10	27	20
Commercial	67	79	167	201
Consumer	8	1	20	13
Totals	105	219	273	446
Net charge-offs	(182)	(349)	(1,177)	(1,132)
Provision for credit losses	345	605	1,746	1,430
Allowance balance - end of period	\$ 9,295	\$ 8,614	\$ 9,295	\$ 8,614
Average loans outstanding during the period	\$ 1,034,553	\$ 836,955	\$ 956,694	\$ 811,747
Net charge-offs (annualized) as a percentage of average loans outstanding during the period	0.07%	0.17%	0.16%	0.19%
Allowance for credit losses at period end as a percentage of total period end loans	0.89%	1.00%	0.89%	1.00%

Nonperforming Assets and Accruing TDRs

As shown in the following table, nonperforming assets decreased \$3.4 million to \$8.1 million at September 30, 2017 from \$11.5 million at December 31, 2016, primarily due to decreases in nonaccrual loans of \$2.7 million and other real estate owned of \$668 thousand. Accruing TDRs increased \$493 thousand to \$13.5 million at September 30, 2017 from \$13.0 million at December 31, 2016. This increase was primarily due to a significant nonaccrual TDR being upgraded to an accruing TDR during the third quarter of 2017. The ratio of nonaccrual loans to total loans decreased to 0.60% at September 30, 2017 from 1.03% at December 31, 2016 which was primarily due to the acquired performing loans from NWBI . Excluding the acquired loans from NWBI the ratio of nonaccrual loans to total loans decreased to 0.68% at September 30, 2017.

The Company continues to focus on the resolution of its nonperforming and problem loans. The efforts to accomplish this goal include frequently contacting borrowers until the delinquency is cured or until an acceptable payment plan has been agreed upon; obtaining updated appraisals; provisioning for credit losses; charging-off loans; transferring loans to other real estate owned; aggressively marketing other real estate owned; and selling loans. The reduction of nonperforming and problem loans is and will continue to be a high priority for the Company.

The following table summarizes our nonperforming assets and accruing TDRs at September 30, 2017 and December 31, 2016 .

(Dollars in thousands)	September 30, 2017	December 31, 2016
Nonperforming assets		
Nonaccrual loans		
Construction	\$ 2,953	\$ 3,818
Residential real estate	2,565	3,903
Commercial real estate	430	1,152
Commercial	341	-
Consumer	-	99
Total nonaccrual loans	6,289	8,972
Loans 90 days or more past due and still accruing		
Construction	-	-
Residential real estate	5	-
Commercial real estate	-	-
Commercial	-	10
Consumer	-	10
Total loans 90 days or more past due and still accruing	5	20
Other real estate owned	1,809	2,477
Total nonperforming assets	\$ 8,103	\$ 11,469
Accruing TDRs		
Construction	\$ 4,033	\$ 4,189
Residential real estate	4,625	3,875
Commercial real estate	4,835	4,936
Commercial	-	-
Consumer	-	-
Total accruing TDRs	\$ 13,493	\$ 13,000
Total nonperforming assets and accruing TDRs	\$ 21,596	\$ 24,469
As a percent of total loans:		
Nonaccrual loans	0.60 %	1.03 %
Accruing TDRs	1.29 %	1.49 %
Nonaccrual loans and accruing TDRs	1.89 %	2.52 %
As a percent of total loans and other real estate owned:		
Nonperforming assets	0.77 %	1.31 %
Nonperforming assets and accruing TDRs	2.06 %	2.80 %
As a percent of total assets:		
Nonaccrual loans	0.46 %	0.77 %
Nonperforming assets	0.59 %	0.99 %
Accruing TDRs	0.98 %	1.12 %
Nonperforming assets and accruing TDRs	1.57 %	2.11 %

Investment Securities

The investment portfolio is comprised of securities that are either available for sale or held to maturity. Investment securities available for sale are stated at estimated fair value based on quoted prices. They represent securities which may be sold as part of the asset/liability management strategy or in response to changing interest rates. Net unrealized holding gains and losses on these securities are reported net of related income taxes as accumulated other comprehensive income, a separate component of stockholders' equity. Investment securities in the held to maturity category are stated at cost adjusted for amortization of premiums and accretion of discounts. We have the intent and current ability to hold such securities until maturity. At September 30, 2017 and December 31, 2016, 97 % of the portfolio was classified as available for sale and 3% as held to maturity. With the exception of municipal securities, our general practice is to classify all newly-purchased securities as available for sale. See Note 3 - Investment Securities, in the Notes to Consolidated Financial Statements for additional details on the composition of our investment portfolio.

Investment securities totaled \$219.6 million at September 30, 2017, a \$49.0 million, or 28.7%, increase since December 31, 2016. The increase was due to utilizing the net cash received from the NWBI branch acquisition to purchase available-for-sale securities. At the end of September 2017, 75.3% of the securities available for sale were mortgage-backed and 24.4% were U.S. Government agencies, compared to 78.7%, and 20.9%, respectively, at year-end 2016. Our investments in mortgage-backed securities are issued or guaranteed by U.S. Government agencies or government-sponsored agencies.

Deposits

Total deposits at September 30, 2017 were \$1.2 billion, a \$208.7 million, or 20.9%, increase when compared to the level at December 31, 2016. The increase was primarily the result of the acquisition of three branches from NWBI which contributed \$212.5 million in total deposits, which had a balance of \$199.9 million at September 30, 2017. Excluding the deposits acquired from the branch purchase, the Company experienced increases in noninterest-bearing deposits of \$50.6 million and interest-bearing checking deposits of \$21.7 million, partially offset by declines in money market and savings deposits of \$22.6 million and time deposits of \$40.8 million.

Short-Term Borrowings

Short-term borrowings at September 30, 2017 and December 31, 2016 were \$1.5 million and \$3.2 million, respectively. The decrease in short-term borrowings was the result of utilizing cash received in the branch acquisition to reduce these borrowings which tend to have higher rates than core deposits. Short-term borrowings generally consist of securities sold under agreements to repurchase, which are issued in conjunction with cash management services for commercial depositors, overnight borrowings from correspondent banks and short-term advances from the Federal Home Loan Bank (the "FHLB"). Short-term advances are defined as those with original maturities of one year or less. At September 30, 2017 and December 31, 2016, short-term borrowings included only repurchase agreements.

Liquidity and Capital Resources

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. As seen in the Consolidated Statements of Cash Flows in the Financial Statements, the net decrease in cash and cash equivalents was \$32.0 million for the first nine months of 2017 compared to an increase in cash of \$1.3 million for the first nine months of 2016. The decrease in cash and cash equivalents in 2017 was mainly due to receiving excess cash from the NWBI branch transaction which was used to purchase available-for-sale securities and paydown short-term borrowings.

To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. The Bank had \$15 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at September 30, 2017 and December 31, 2016. The Bank is also a member of the FHLB, which provides another source of liquidity. Through the FHLB, the Bank had credit availability of approximately \$222.0 million and \$205.1 million at September 30, 2017 and December 31, 2016, respectively. These lines of credit are paid for monthly on a fee basis of 0.425%. The Bank has pledged, under a blanket lien, all qualifying residential and commercial real estate loans under borrowing agreements with the FHLB. Management is not aware of any demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity increased \$8.3 million to \$162.6 million at September 30, 2017 when compared to December 31, 2016 primarily due to current year's earnings.

Basel III

The FRB and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's ("BCBS") capital guidelines for U.S. banks. Under the final rules, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules included a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total Capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, was also established above the regulatory minimum capital requirements. This capital conservation buffer became effective as of January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revise the definition and calculation of Tier 1 capital, Total Capital, and risk-weighted assets.

The phase-in period for the final rules became effective for the Company on January 1, 2015, with full compliance with all of the final rules' requirements phased in over a multi-year schedule, to be fully phased-in by January 1, 2019. As of September 30, 2017, the Company's capital levels remained characterized as "well-capitalized" under the new rules.

The following tables present the capital ratios for Shore Bancshares, Inc. and Shore United Bank as of September 30, 2017 and December 31, 2016.

During the first quarter of 2017, Shore Bancshares, Inc. contributed \$10.5 million in capital to its bank subsidiary, Shore United Bank, in preparation for the branch acquisition in the second quarter of 2017. Of the \$10.5 million contributed, \$10.2 million consisted of mortgage-backed securities and \$300 thousand consisted of cash.

	Tier 1 leverage ratio	Common Equity Tier 1 ratio	Tier 1 risk-based capital ratio	Total risk-based capital ratio
September 30, 2017				
Company	9.72 %	12.13 %	12.13 %	13.02 %
Shore United Bank	9.31 %	11.60 %	11.60 %	12.50 %
	Tier 1 leverage ratio	Common Equity Tier 1 ratio	Tier 1 risk-based capital ratio	Total risk-based capital ratio
December 31, 2016				
Company	12.31 %	15.78 %	15.78 %	16.79 %
Shore United Bank	10.88 %	13.84 %	13.84 %	14.86 %

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Our primary market risk is interest rate fluctuation and management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the 2016 Annual Report under the caption “Market Risk Management and Interest Sensitivity”. Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2016.

Item 4. Controls and Procedures.

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that Shore Bancshares, Inc. files under the Securities Exchange Act of 1934 with the SEC, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in those rules and forms, and that such information is accumulated and communicated to management, including Shore Bancshares, Inc.’s principal executive officer (“CEO”) and its principal accounting officer (“PAO”), as appropriate, to allow for timely decisions regarding required disclosure. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

An evaluation of the effectiveness of these disclosure controls and procedures as of September 30, 2017 was carried out under the supervision and with the participation of management, including the CEO and the PAO. Based on that evaluation, the Company’s management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level at September 30, 2017.

There was no change in our internal control over financial reporting during the third quarter of 2017 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

From time to time the Company may become involved in legal proceedings. At the present time, there are no proceedings which the Company believes will have a material adverse impact on the financial condition or earnings of the Company.

Item 1A. Risk Factors

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the 2016 Annual Report. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed in our 2016 Annual Report.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

Not Applicable

Item 5. Other Information

None

Item 6. Exhibits

The exhibits filed or furnished with this quarterly report are shown on the Exhibit List that follows the signatures to this report, which list is incorporated herein by reference.

SIGNATURES

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

SHORE BANCSHARES, INC.

Date: November 9, 2017

By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President & Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2017

By: /s/ Edward C. Allen
Edward C. Allen
Senior Vice President & Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

Exhibit Number	Description
<u>10.1</u>	<u>Amended and Restated Employment Agreement, dated October 31, 2017, between Shore Bancshares, Inc. and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on November 1, 2017)</u>
<u>10.2</u>	<u>Employment Agreement, dated October 31, 2017, between Shore Bancshares, Inc. and Donna J. Stevens (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on November 1, 2017)</u>
<u>10.3</u>	<u>Employment Agreement, dated October 31, 2017, between Shore United Bank and Patrick M. Bilbrough (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on November 1, 2017)</u>
<u>10.4</u>	<u>Change in Control Agreement, dated October 31, 2017, between Shore United Bank and Edward C. Allen (incorporated by reference to Exhibit 10.4 to the Company's Form 8-K filed on November 1, 2017)</u>
<u>10.5</u>	<u>Change in Control Agreement, dated October 31, 2017, between The Avon-Dixon Agency, LLC and Richard C. Trippe (incorporated by reference to Exhibit 10.5 to the Company's Form 8-K filed on November 1, 2017)</u>
<u>31.1</u>	<u>Certifications of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).</u>
<u>31.2</u>	<u>Certifications of the Principal Accounting Officer pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).</u>
<u>32</u>	<u>Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).</u>
101	Interactive Data File
101.INS	XBRL Instance Document (filed herewith)
101.SCH	XBRL Taxonomy Extension Schema (filed herewith)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase (filed herewith)
101.DEF	XBRL Taxonomy Extension Definition Linkbase (filed herewith)
101.LAB	XBRL Taxonomy Extension Label Linkbase (filed herewith)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase (filed herewith)

**Certifications of the Principal Executive Officer
Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14
As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Lloyd L. Beatty, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shore Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2017

By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President & Chief Executive Officer
(Principal Executive Officer)

**Certifications of the Principal Accounting Officer
Pursuant to Securities Exchange Act Rules 13a-14 and 15d-14
As adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Edward C. Allen, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Shore Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2017

By: /s/ Edward C. Allen
Edward C. Allen
Senior Vice President & Chief Financial Officer
(Principal Financial Officer)

Certification of Periodic Report
Pursuant to 18 U.S.C. Section 1350
As adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to, and for purposes only of, 18 U.S.C. § 1350, the undersigned hereby certifies that (i) the Quarterly Report of Shore Bancshares, Inc. on Form 10-Q for the quarter ended September 30, 2017 filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and (ii) information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Shore Bancshares, Inc.

Date: November 9, 2017

By: /s/ Lloyd L. Beatty, Jr.
Lloyd L. Beatty, Jr.
President & Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2017

By: /s/ Edward C. Allen
Edward C. Allen
Senior Vice President & Chief Financial Officer
(Principal Financial Officer)
