

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

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-K/A**

**(Amendment No. 1)**

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

For the Year Ended December 31, 2017

Commission File No. 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

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

28969 Information Lane, Easton, Maryland 21601

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(Address of Principal Executive Offices) (Zip Code)

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

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

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

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

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

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

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

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

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

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

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 Exchange Act): Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$ 203,644,667.

The number of shares outstanding of the registrant's common stock as of the latest practicable date: 12,735,918 as of February 28, 2018.

### **Documents Incorporated by Reference**

None.

## **Explanatory Note**

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

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

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

**Item 8. Financial Statements and Supplementary Data.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

<u>Management's Report on Internal Control over Financial Reporting</u>	<u>2</u>
<u>Reports of Independent Registered Public Accounting Firms</u>	<u>3</u>
<u>Consolidated Balance Sheets</u>	<u>7</u>
<u>Consolidated Statements of Income</u>	<u>8</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>9</u>
<u>Consolidated Statements of Changes in Stockholders' Equity</u>	<u>10</u>
<u>Consolidated Statements of Cash Flows</u>	<u>11</u>
<u>Notes to Consolidated Financial Statements</u>	<u>13</u>

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

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

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

March 16, 2018

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

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



## **Report of Independent Registered Public Accounting Firm**

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

### **Opinion on the Financial Statements**

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

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

### **Basis for Opinion**

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

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



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

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

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

Winchester, Virginia  
March 16, 2018

## **Report of Independent Registered Public Accounting Firm**

To the Stockholders and the Board of Directors

Shore Bancshares, Inc.

Easton, Maryland

### **Opinion on the Internal Control Over Financial Reporting**

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

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

### **Basis for Opinion**

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

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

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

### **Definition and Limitations of Internal Control Over Financial Reporting**

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

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

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

Winchester, Virginia

March 16, 2018

Report Of Independent Registered Public Accounting Firm

Board of Directors and Stockholders

Shore Bancshares, Inc.

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

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

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

/s/ Dixon Hughes Goodman LLP

Baltimore, Maryland

March 16, 2017



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and

Stockholders of Shore Bancshares, Inc.

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

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

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

/s/ Stegman & Company

Baltimore, Maryland

March 11, 2016

## SHORE BANCSHARES, INC.

## CONSOLIDATED BALANCE SHEETS

December 31,

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

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



## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,

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

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

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

SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the Years Ended December 31,

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

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

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

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

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

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

## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,

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



## SHORE BANCSHARES, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the Years Ended December 31,

## CASH FLOWS FROM FINANCING ACTIVITIES:

Net changes in:

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

Supplemental cash flows information:

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

Branch purchase:

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

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

**SHORE BANCSHARES, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

**NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

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

**Nature of Operations**

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

**Use of Estimates**

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



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

### **Investment Securities Available for Sale**

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

### **Investment Securities Held to Maturity**

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

## Loans

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

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

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

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

### **Allowance for Credit Losses**

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

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

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

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

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

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

### **Premises and Equipment**

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

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

### **Goodwill and Other Intangible Assets**

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

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

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

### **Other Real Estate Owned**

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

### **Short-Term Borrowings**

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

### **Income Taxes**

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

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which

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

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

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

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

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

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

### **Basic and Diluted Earnings Per Common Share**

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

### **Transfers of Financial Assets**

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

### **Cash and Cash Equivalents**

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

### **Share-Based Compensation**

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



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

### **Fair Value**

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

### **Advertising Costs**

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

### **Comprehensive Income**

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

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

## **Recent Accounting Standards**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## NOTE 2. BUSINESS COMBINATION

### *Northwest Bank Branch Acquisition*

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

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

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

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

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

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

### ***Acquired loans***

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

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

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

**NOTE 3. INVESTMENT SECURITIES**

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

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

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

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

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

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

Held-to-maturity securities:

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

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

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

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

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

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

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

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

#### **NOTE 4. LOANS AND ALLOWANCE FOR CREDIT LOSSES**

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

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

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

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

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

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

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

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

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

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

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

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

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

Allowance for credit losses allocated to:

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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(Dollars in thousands)	Current	past due	past due	90 days	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	\$852,410	\$ 5,029	\$ 5,094	\$ 20	\$ 10,143	\$ 8,972	\$871,525
Percent of total loans	97.8	% 0.6	% 0.6	% -	% 1.2	% 1.0	% 100.0

The following tables provide a summary of the activity in the allowance for credit losses allocated by loan class for 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.

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
2017							
Allowance for credit losses:							
Beginning Balance	\$ 2,787	\$ 1,953	\$ 2,610	\$ 1,145	\$ 231	\$ -	\$8,726
Charge-offs	(54 )	(445 )	(100 )	(946 )	(32 )	-	(1,577)
Recoveries	30	40	31	215	25	-	341
Net charge-offs	(24 )	(405 )	(69 )	(731 )	(7 )	-	(1,236)
Provision	(303 )	736	53	1,827	(22 )	-	2,291
Ending Balance	\$ 2,460	\$ 2,284	\$ 2,594	\$ 2,241	\$ 202	\$ -	\$9,781

(Dollars in thousands)	Construction	Residential real estate	Commercial real estate	Commercial	Consumer	Unallocated	Total
2016							
Allowance for credit losses:							
Beginning Balance	\$ 1,646	\$ 2,181	\$ 2,999	\$ 558	\$ 156	\$ 776	\$8,316
Charge-offs	(615 )	(580 )	(503 )	(497 )	(45 )	-	(2,240)
Recoveries	35	298	25	428	16	-	802
Net charge-offs	(580 )	(282 )	(478 )	(69 )	(29 )	-	(1,438)
Provision	1,721	54	89	656	104	(776 )	1,848
Ending Balance	\$ 2,787	\$ 1,953	\$ 2,610	\$ 1,145	\$ 231	\$ -	\$8,726

### Foreclosure Proceedings

Consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure totaled \$530 thousand and \$687 thousand as of December 31, 2017 and 2016. There were no residential real estate included in the balance of Other real estate owned at December 31, 2017 and \$18 thousand included in the balance for two residential properties at December 31, 2016.

Performing TDRs were in compliance with their modified terms and there are no further commitments associated with these loans.



**NOTE 5. PREMISES AND EQUIPMENT**

The following table provides information on premises and equipment at December 31, 2017 and 2016.

(Dollars in thousands)	2017	2016
Land	\$7,884	\$5,818
Buildings and land improvements	20,345	16,296
Furniture and equipment	6,240	6,746
	34,469	28,860
Accumulated depreciation	(11,415)	(12,302)
Total	\$23,054	\$16,558

Depreciation expense totaled \$1.1 million, \$1.0 million and \$912 thousand for 2017, 2016, and 2015, respectively.

The Company leases facilities under operating leases. Rental expense for the years ended December 31, 2017, 2016, and 2015 was \$717 thousand, \$660 thousand and \$650 thousand, respectively. Future minimum annual rental payments are approximately as follows:

(Dollars in thousands)	
2018	\$763
2019	680
2020	471
2021	429
2022	436
Thereafter	2,130
Total minimum lease payments	\$4,909

**NOTE 6. INVESTMENT IN UNCONSOLIDATED SUBSIDIARIES**

The Avon-Dixon Agency, LLC (“Avon-Dixon”), a wholly-owned insurance subsidiary of the Company, owns a 40% interest in a segregated portfolio of Eastern Re Ltd., SPC (“Eastern”), a specialty reinsurance company. This investment is measured using the equity method and is carried at cost, adjusted for Avon-Dixon’s equity ownership in Eastern’s net income or loss. At December 31, 2017 and 2016, the carrying value of the investment in Eastern was \$789 thousand and \$361 thousand, respectively. During 2017 and 2016, income recognized from the investment in Eastern was \$428 thousand and \$41 thousand, respectively.



**NOTE 7. GOODWILL AND OTHER INTANGIBLE ASSETS**

The following table provides information on the significant components of goodwill and other acquired intangible assets at December 31, 2017 and 2016. 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 \$15.0 million. The Insurance segment had goodwill of \$10.1 million at the end of 2017 and \$9.4 million at the end of 2016 due to an immaterial reclassification between goodwill and deferred taxes of \$702 thousand identified during 2017. See Note 27 for further information regarding the Company's business segments.

December 31, 2017

(Dollars in thousands)	Gross Carrying Amount	Accumulated Impairment Charges	Accumulated Amortization	Net Carrying Amount	Weighted Average Remaining Life (in years)
Goodwill	\$ 30,922	\$ (2,637 )	\$ (667 )	\$ 27,618	-
Other intangible assets					
Amortizable					
Employment agreements	\$ 440	\$ -	\$ (440 )	\$ -	-
Insurance expirations	1,270	-	(1,270 )	-	-
Customer relationships	795	(95 )	(484 )	216	4.6
Core deposit intangible	3,954	-	(231 )	3,723	9.4
	6,459	(95 )	(2,425 )	3,939	
Unamortizable					
Trade name	780	-	-	780	-
	780	-	-	780	
Total other intangible assets	\$ 7,239	\$ (95 )	\$ (2,425 )	\$ 4,719	

December 31, 2016

	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

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Customer relationships	795	(95	)	(438	)	262	5.6
	2,505	(95	)	(2,111	)	299	
Unamortizable							
Carrier relationships	-	-		-		-	-
Trade name	780	-		-		780	-
	780	-		-		780	
Total other intangible assets	\$3,285	\$ (95	)	\$ (2,111	)	\$1,079	

The aggregate amortization expense was \$314 thousand, \$131 thousand, and \$133 thousand for the years ended December 31, 2017, 2016, and 2015 respectively.

The following table provides information on current period and estimated future amortization expense for amortizable other intangible assets.

(Dollars in thousands)	Amortization Expense
Estimate for years ended December 31, 2018	\$ 442
2019	442
2020	442
2021	439
2022	427
Thereafter	1,747

#### **NOTE 8. OTHER ASSETS**

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

(Dollars in thousands)	2017	2016
Restricted securities	\$3,735	\$1,650
Accrued interest receivable	3,502	2,675
Deferred income taxes	1,935	7,040
Prepaid expenses	1,475	1,148
Cash surrender value on life insurance	3,637	2,589
Other assets	3,636	3,781
Total	\$17,920	\$18,883

#### **NOTE 9. OTHER LIABILITIES**

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

(Dollars in thousands)	2017	2016
Accrued interest payable	\$65	\$74
Other accounts payable	4,286	3,347
Deferred compensation liability	1,219	1,444
Other liabilities	39	415
Total	\$5,609	\$5,280



**NOTE 10. DEPOSITS**

The approximate amount of certificates of deposit of \$250,000 or more was \$25.3 million and \$29.1 million at December 31, 2017 and 2016, respectively.

The following table provides information on the approximate maturities of total time deposits at December 31, 2017 and 2016.

(Dollars in thousands)	2017	2016
Due in one year or less	\$142,880	\$154,328
Due in one to three years	70,285	60,795
Due in three to five years	49,650	45,145
Total	\$262,815	\$260,268

As of December 31, 2017 and 2016, deposits, both direct and indirect, to directors, their associates and policy-making officers, totaled approximately \$3.6 million and \$4.6 million, respectively.

At December 31, 2017 we had \$8.4 million in brokered deposits and \$20.1 at December 31, 2016.

**NOTE 11. SHORT-TERM BORROWINGS**

The following table summarizes certain information on short-term borrowings for the years ended December 31, 2017 and 2016.

(Dollars in thousands)	2017		2016	
	Amount	Rate	Amount	Rate
Average for the Year				
Repurchase agreements	\$3,324	0.49%	\$5,753	0.24%
FHLB Advances	1,183	1.20	-	-
Overnight Fed Funds purchased	18	1.84	-	-
At Year End				
Repurchase agreements	\$6,072	0.78%	\$3,203	0.25%
FHLB Advances	15,662	1.63	-	-
Overnight Fed Funds purchased	-	-	-	-

Securities sold under agreements to repurchase are securities sold to customers, at the customers' request, under a "roll-over" contract that matures in one business day. The underlying securities sold are U.S. Government agency securities, which are segregated in the Company's custodial accounts from other investment securities.

The Company may periodically borrow from a correspondent federal funds line of credit arrangement, under a secured reverse repurchase agreement, or from the Federal Home Loan Bank to meet short-term liquidity needs.

**NOTE 12. BENEFIT PLANS****401(k) and Profit Sharing Plan**

The Company has a 401(k) and profit sharing plan covering substantially all full-time employees. The plan calls for matching contributions by the Company, and the Company makes discretionary contributions based on profits. Company contributions to this plan included in expense totaled \$625 thousand, \$539 thousand, and \$491 thousand for 2017, 2016, and 2015, respectively.

**NOTE 13. 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 708,416 shares remained available for grant at December 31, 2017.

The following tables provide information on stock-based compensation expense for 2017, 2016, and 2015.

(Dollars in thousands)	December 31,		
	2017	2016	2015
Stock-based compensation expense	\$1,055	\$334	\$283
Excess tax benefits related to stock-based compensation	28	27	3

(Dollars in thousands)	December 31,		
	2017	2016	2015
Unrecognized stock-based compensation expense	\$801	\$337	\$222
Weighted average period unrecognized expense is expected to be recognized	1.0 years	0.9 years	1.5 years

The following table summarizes restricted stock award activity for the Company under the 2016 Equity Plan for the three years ended December 31, 2017.

	Year Ended December 31, 2017		Year Ended December 31, 2016		Year Ended December 31, 2015	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at beginning of period	17,066	\$ 11.46	12,488	\$ 8.74	14,251	\$ 8.51
Granted	22,927	16.71	27,366	11.51	12,647	9.21
Vested	(24,080 )	13.86	(22,788 )	10.01	(14,410 )	8.93
Cancelled	-	-	-	-	-	-
Nonvested at end of period	15,913	\$ 15.39	17,066	\$ 11.46	12,488	\$ 8.74

The total fair value of restricted stock awards that vested was \$334 thousand in 2017, \$228 thousand in 2016, and \$129 thousand in 2015.

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 for the Company under the 2016 and 2006 Equity Plans for the three years ended December 31, 2017.

	Year Ended December 31, 2017		Year Ended December 31, 2016		Year Ended December 31, 2015	
	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value	Number of Shares	Weighted Average Grant Date Fair Value
Outstanding at beginning of period	46,342	\$ 10.64	26,943	\$ 9.49	-	\$ -
Granted	43,924	13.59	24,433	11.68	26,943	9.49
Vested	-	-	-	-	-	-
Forfeited	-	-	(5,034 )	9.49	-	-
Outstanding at end of period	90,266	\$ 12.08	46,342	\$ 10.64	26,943	\$ 9.49

The following table summarizes stock option activity for the Company under the 2016 Equity Plan for the three years ended December 31, 2017.

	Year Ended December 31, 2017		Year Ended December 31, 2016		Year Ended December 31, 2015	
	Number of Shares	Weighted Average Exercise Prices	Number of Shares	Weighted Average Exercise Prices	Number of Shares	Weighted Average Exercise Prices
Outstanding at beginning of period	62,086	\$ 8.29	61,327	\$ 8.05	27,108	\$ 6.64
Granted	1,202	16.65	12,443	11.12	34,219	9.18
Exercised	(859 )	6.64	(11,684 )	6.64	-	-
Expired/Cancelled	-	-	-	-	-	-
Outstanding at end of period	62,429	\$ 8.47	62,086	\$ 8.29	61,327	\$ 8.05
Exercisable at end of period	61,828	\$ 8.40	58,756	\$ 8.14	44,218	\$ 7.62

The weighted average fair value of stock options granted during 2017 was \$10.99, \$5.03 for 2016 and \$3.44 for 2015. 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	2015
Dividend yield	0.84	% 0.73	% - %
Expected volatility	64.80	% 38.60	% 32.00 %
Risk-free interest rate	2.42	% 1.75	% 1.97 %
Expected contract life (in years)	<b>10 years</b>	10 years	7 years

At December 31, 2017, the aggregate intrinsic value of the options outstanding under the 2016 Equity Plan was \$513 thousand based on the \$16.70 market value per share of Shore Bancshares, Inc.'s common stock at December 31, 2017. Similarly, the aggregate intrinsic value of the options exercisable was \$513 thousand at December 31, 2017. The intrinsic value on options exercised during 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 December 31, 2017, the weighted average remaining contract life of options outstanding and exercisable was 6.1 years.

#### NOTE 14. DEFERRED COMPENSATION

The Shore Bancshares, Inc. Executive Deferred Compensation Plan (the "Plan") is for members of management and highly compensated employees of Shore Bancshares, Inc. and its subsidiaries. The Plan permits a participant to elect, each year, to defer receipt of up to 100% of his or her salary and bonus to be earned in the following year. The Plan also permits the participant to defer the receipt of performance-based compensation not later than six months before the end of the period for which it is to be earned. The deferred amounts are credited to an account maintained on behalf of the participant and are invested at the discretion of each participant in certain deemed investment options selected from time to time by the Compensation Committee of the Board of Shore Bancshares, Inc. Shore Bancshares, Inc. may also make matching, mandatory and discretionary contributions for certain participants. A participant is fully vested at all times in the amounts that he or she elects to defer. Any contributions by Shore Bancshares, Inc. will vest over a five-year period. There were no elective deferrals made by plan participants during 2017, 2016 or 2015.

The following table provides information on Shore Bancshares, Inc.'s contributions to the Plan for 2017, 2016, and 2015 and the related deferred compensation liability at December 31, 2017 and 2016.

(Dollars in thousands)	2017	2016	2015
Deferred compensation contribution	\$ -	\$ -	\$ -

(Dollars in thousands)	December 31,	
	2017	2016
Deferred compensation liability	\$ 393	\$ 496

Shore United Bank assumed agreements held by the former CNB Bank under which its former directors had elected to defer part of their fees and compensation while serving on the former Board of CNB. The amounts deferred are invested in insurance policies, on the lives of the respective individuals. Amounts available under the policies are to be paid to the individuals as retirement benefits over future years. The following table includes information on the cash surrender value and the accrued benefit obligation included in other assets and other liabilities at December 31, 2017 and 2016.

(Dollars in thousands)	2017	2016
Cash surrender value	\$3,637	\$3,552
Accrued benefit obligation	826	1,444

#### NOTE 15. OTHER EXPENSES

The following table summarizes the Company's other noninterest expenses for the years ended December 31:

(Dollars in thousands)	2017	2016	2015
Advertising and marketing	\$662	\$528	\$495
Other customer expense	393	279	172
Other expense	1,969	2,096	2,168
Other loan expense	271	247	351
Software expense	1,051	895	697
Travel and entertainment expense	387	315	303
Trust professional fees	529	539	625
Total noninterest expense	\$5,262	\$4,899	\$4,811



**NOTE 16. INCOME TAXES**

The following table provides information on components of income tax expense for each of the three years ended December 31.

(Dollars in thousands)	2017	2016	2015
Current tax expense:			
Federal	\$4,047	\$525	\$247
State	-	19	287
	4,047	544	534
Deferred income tax expense:			
Federal	2,903	4,486	3,369
State	1,573	1,231	505
	4,476	5,717	3,874
Total income tax expense	\$8,523	\$6,261	\$4,408

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

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

Provisional amounts of the following income tax effects of the Tax Act have been recorded as of December 31, 2017 and are subject to change during 2018.

#### *One-time transition tax*

The Tax Act requires the Company to pay U.S. income taxes on accumulated foreign subsidiary earnings not previously subject to U.S. income tax at a rate of 15.5% to the extent foreign cash and certain other net current assets and 8% on the remaining earnings. The Company recorded a provisional amount for its one-time transitional tax liability and income tax expense of \$100.1 thousand. The Company recorded provisional amounts based on estimates of the effects of the Tax Act as the analysis requires significant data from its foreign subsidiary that is not regularly collected or analyzed.

#### *Deferred tax effects*

The Tax Act reduces the U.S. statutory tax rate from 35% to 21% for years after 2017. Accordingly, the Company remeasured its deferred taxes as of December 31, 2017 to reflect the reduced tax rate that will apply in future periods when these deferred taxes are settled or realized. The Company recognized a deferred tax reduction of \$582 thousand to reflect the reduced U.S. tax rate and other effects of the Tax Act. Although the tax rate reduction is known, the Company has not collected the necessary data to complete its analysis of the effect of the Tax Act on the underlying deferred taxes and as such, the amounts recorded as of December 31, 2017 are provisional.

The net tax expense recognized in 2017 related to the Tax Act was \$582 thousand. As the Company completes its analysis of the Tax Act and incorporated additional guidance that may be issued by the U.S. Treasury Department, the

IRS or other standard-setting bodies, it may identify additional effects not reflected as of December 31, 2017.

The following table provides a reconciliation of tax computed at the statutory federal tax rate to the actual tax expense (benefit) for each of the three years ended December 31.

(Dollars in thousands)	2017	2016	2015
Tax at federal statutory rate	35.0%	35.0%	34.0%
Tax effect of:			
Tax-exempt income	(1.0 )	(0.8 )	(0.4 )
Other non-deductible expenses	0.1	0.3	0.2
State income taxes, net of federal benefit	5.2	5.1	4.5
Tax impact from enacted change in tax rate	2.9	-	-
Other	0.9	(0.2 )	(0.1 )
Actual income tax expense rate	43.1%	39.4%	38.2%

The following table provides information on significant components of the Company's deferred tax assets and liabilities as of December 31. The Company recorded a provisional adjustment to our U.S. deferred income taxes as of December 31, 2017 to reflect the reduction in the U.S. statutory tax rate from 35% to 21% resulting from the Tax Act.

(Dollars in thousands)	2017	2016
Deferred tax assets:		
Allowance for credit losses	\$2,625	\$3,486
Reserve for off-balance sheet commitments	81	122
Net operating loss carry forward	741	2,232
Write-downs of other real estate owned	212	387
Deferred income	95	1,011
Unrealized losses on available-for-sale securities	460	630
Unrealized losses on available-for-sale securities transferred to held to maturity	20	42
AMT Credits	-	869
Other	635	1,192
Total deferred tax assets	4,869	9,971
Deferred tax liabilities:		
Depreciation	408	239
Amortization on loans FMV adjustment	84	156
Purchase accounting adjustments	1,994	2,019
Deferred capital gain on branch sale	207	401
Other	241	116
Total deferred tax liabilities	2,934	2,931
Net deferred tax assets	\$1,935	\$7,040

The Company's deferred tax assets consist of gross net operating loss carryovers for state tax purposes of \$12.1 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 federal NOL exists as of December 31, 2017.

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

## NOTE 17. EARNINGS PER COMMON SHARE

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Basic earnings per common share is calculated by dividing net income available to (allocable 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 (allocable 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)	2017	2016	2015
Net income	\$11,262	\$9,638	\$7,108
Weighted average shares outstanding - basic	12,682	12,652	12,629
Dilutive effect of common stock equivalents-options	22	17	10
Dilutive effect of common stock equivalents-restricted stock units	14	-	-
Weighted average shares outstanding - diluted	12,718	12,669	12,639
Income per common share - basic	\$0.89	\$0.76	\$0.56
Income per common share - diluted	\$0.89	\$0.76	\$0.56

The calculations of diluted income per common share excluded no weighted average common stock equivalents, for all of the periods presented because the effect of including them would have anti-dilutive.

## **NOTE 18. REGULATORY CAPITAL REQUIREMENTS**

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

### *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 include 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 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, is also established above the regulatory minimum capital requirements. This capital conservation buffer was phased in beginning January 1, 2016 at 0.625% of risk-weighted assets and 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. At December 31, 2017 the capital conservation buffer was 1.25% and the Bank specific capital buffer was 4.36%.

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.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain amounts and ratios (set forth in the table below) of Tier 1 and total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (leverage ratio). As of December 31, 2017, management

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believes that Shore Bancshares, Inc. and Shore United Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2017, the most recent notification from the Federal Reserve Bank categorized Shore United Bank, as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes would change the Bank's classification. To be categorized as well capitalized, the Bank must maintain minimum common equity Tier 1, Tier 1 risk-based and total risk-based capital ratios, and Tier 1 leverage ratios, which are described below.

The minimum ratios for capital adequacy purposes are 5.75%, 7.25%, 9.25% and 4.000% for the common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, which includes a capital conservation buffer of 1.25% respectively. To be categorized as well capitalized, a bank must maintain minimum ratios of 6.50%, 8.00%, 10.00% and 5.00% for its common equity Tier 1, Tier 1 risk-based capital, total risk-based capital and leverage ratios, respectively. Shore Bancshares, Inc., as a financial holding company, is subject to the well-capitalized requirement.

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

(Dollars in thousands)	Common Equity/Tier 1 Capital	Total Risk-Based Capital	Net Risk-Weighted Assets	Adjusted Average Total Assets	Common Equity Tier 1 ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Tier 1 Leverage Ratio
December 31, 2017								
Company	\$132,370	\$142,452	\$1,112,259	\$1,345,876	11.90 %	11.90 %	12.81 %	9.84 %
Shore United Bank	126,751	136,833	1,107,074	1,342,484	11.45 %	11.45 %	12.36 %	9.44 %

(Dollars in thousands)	Common Equity/Tier 1 Capital	Total Risk-Based Capital	Net Risk-Weighted Assets	Adjusted Average Total Assets	Common Equity Tier 1 ratio	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Tier 1 Leverage Ratio
December 31, 2016								
Company	\$140,897	\$149,924	\$893,116	\$1,144,968	15.78 %	15.78 %	16.79 %	12.31 %
Shore United Bank	122,543	131,570	885,206	1,126,136	13.84 %	13.84 %	14.86 %	10.88 %

Bank and holding company regulations, as well as Maryland law, impose certain restrictions on dividend payments by the Bank, as well as restricting extensions of credit and transfers of assets between the Bank and the Company.

At December 31, 2017, the Bank could pay dividends to the parent to the extent of its earnings so long as it maintained required capital ratios. The Bank did not pay any dividends to Shore Bancshares, Inc. during 2017. Shore Bancshares, Inc. had no outstanding receivables from subsidiaries at December 31, 2017 or 2016.

#### NOTE 19. 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 2017 and 2016.

(Dollars in thousands)	Unrealized gains (losses) on available-for-sale securities	Unrealized gains (losses) on securities Available-for-sale to Held-to-maturity	Accumulated other comprehensive income (loss)
Balance, December 31, 2016	\$ (931	) \$ (62	) \$ (993 )
Other comprehensive income (loss)	(105	) 18	(87 )
Reclassification of (gain) recognized	(3	) -	(3 )
Reclassification of stranded tax effects from change in tax rate	(216	) (10	) (226 )
Balance, December 31, 2017	\$ (1,255	) \$ (54	) \$ (1,309 )
Balance, December 31, 2015	\$ 8	\$ (79	) \$ (71 )
Other comprehensive income (loss)	(921	) 17	(904 )
Reclassification of (gain) recognized	(18	) -	(18 )
Balance, December 31, 2016	\$ (931	) \$ (62	) \$ (993 )

The following table presents the amounts reclassified out of each component of accumulated comprehensive income (loss) for the years ended December 31, 2017, 2016, and 2015.

Details about Accumulated Other



Comprehensive Income Components (dollars in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income Year Ended December 31,			Affected Line Item in the Statement Where Net Income is Presented
	2017	2016	2015	
Realized (gains) on available for sale investment securities	\$ (5 )	\$ (30 )	\$ -	Gain on sales and calls of investment securities
Related income tax	\$ 2	\$ 12	-	Income tax expense
Total Reclassification for the Period	\$ (3 )	\$ (18 )	\$ -	

**NOTE 20. LINES OF CREDIT**

The Bank had \$15.0 million and \$15.0 million in federal funds lines of credit and a reverse repurchase agreement available on a short-term basis from correspondent banks at December 31, 2017 and 2016. In addition, the Bank had secured credit availability of approximately \$205.6 million and \$205.1 million from the Federal Home Loan Bank at December 31, 2017 and 2016, respectively. These lines of credit are paid for monthly on a fee basis of 0.08%. The Bank has pledged as collateral, under a blanket lien, all qualifying residential loans under borrowing agreements with the Federal Home Loan Bank. The Bank had short-term borrowings of \$15.7 million from the Federal Home Loan Bank at December 31, 2017 and \$0 at December 31, 2016.

**NOTE 21. 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.

### **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.

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

(Dollars in thousands)	Fair Value	Quoted Prices (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2017				
Securities available for sale:				
U.S. Government agencies	\$ 45,332	\$ -	\$ 45,332	\$ -
Mortgage-backed	150,965	-	150,965	-
Equity	658	-	658	-
Total	\$ 196,955	\$ -	\$ 196,955	\$ -

(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	\$ 163,902	\$ -	\$ 163,902	\$ -

**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 following tables set forth the Company's financial assets subject to fair value adjustments (impairment) on a nonrecurring basis at December 31, 2017 and 2016, that are valued at the lower of cost or market. Assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. The assets in the following table were transferred during 2016 from Level 2 to Level 3, based on management's reassessment an evaluation of the inputs in relation to impaired loans and foreclosed assets. This reassessment resulted in management's conclusion that the inputs for these assets were more reflective of Level 3 as unobservable inputs and applied retrospectively to prior periods reported.

(Dollars in thousands)	Quantitative Information about Level 3 Fair Value Measurements			
	Fair Value	Valuation Technique	Unobservable Input	Range
December 31, 2017				
Nonrecurring measurements:				

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Impaired loans	\$510	Appraisal of collateral	1	Liquidation expense	2	10%
Impaired loans	\$6,005	Discounted cash flow analysis	1	Discount rate		4% - 8.5%
Other real estate owned	\$1,794	Appraisal of collateral	1	Appraisal adjustments	2	20% - 30%
				Liquidation expense	2	5% - 10%

Quantitative Information about Level 3 Fair Value Measurements

(Dollars in thousands)	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%

Fair value is generally determined through independent appraisals of the underlying collateral (impaired loans and (1) OREO) or discounted cash flow analyses (impaired loans), which generally include various level III inputs which are not identifiable.

Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated (2) liquidation expenses. The range of liquidation expenses and other appraisal adjustments are presented as a percent of the appraisal.

## **Fair Value of Financial Assets and Financial Liabilities**

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 policies 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, other 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)	December 31, 2017		December 31, 2016	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Financial assets</b>				
<b>Level 1 inputs</b>				
Cash and cash equivalents	\$31,820	\$31,820	\$75,938	\$75,938
<b>Level 2 inputs</b>				
Investment securities held to maturity	\$6,247	\$6,391	\$6,808	\$6,806
Restricted securities	3,735	3,735	1,650	1,650
Bank owned life insurance	3,637	3,637	3,552	3,552
<b>Level 3 inputs</b>				
Loans, net	1,083,733	1,072,951	862,799	867,594
<b>Financial liabilities</b>				
<b>Level 2 inputs</b>				
<b>Deposits:</b>				
Noninterest-bearing demand	\$328,322	\$328,322	\$261,575	\$261,575
Checking plus interest	231,898	231,898	203,724	203,724
Money market	223,123	223,123	181,871	181,871
Savings	156,623	156,623	90,051	90,051
Club	398	398	393	393
Certificates of deposit, \$100,000 or more	107,343	105,691	120,602	119,914
Other time	155,074	151,339	139,273	135,940
Short-term borrowings	21,734	21,734	3,203	3,203

## NOTE 22. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the normal course of business, to meet the financing needs of its customers, the Bank is party to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. The Banks' exposure to credit loss in the event of nonperformance by the other party to these financial instruments is represented by the contractual amount of the instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments. The Bank generally requires collateral or other security to support the financial instruments with credit risk. The amount of collateral or other security is determined based on management's credit evaluation of the counterparty. The Bank evaluates each customer's creditworthiness on a case-by-case basis.



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 as of December 31, 2017 and 2016.

(Dollars in thousands)	December 31, 2017	December 31, 2016
Commitments to extend credit	\$ 206,065	\$ 178,233
Letters of credit	7,142	8,024
Total	\$ 213,207	\$ 186,257

The Bank has established an allowance for off balance sheet credit exposures. The allowance is established as losses are estimated to have occurred through a loss for off balance sheet credit exposures charged to earnings. Losses are charged against the allowance when management believes the required funding of these exposures is uncollectible. While this evaluation is completed on a regular basis, it is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

**NOTE 23. RELATED PARTY TRANSACTIONS**

Shore Bancshares Inc. and its bank and insurance subsidiaries on occasion rent ballroom space from the Tidewater Inn located in Easton Maryland, to hold company meetings and events. A director of the board of Shore Bancshares Inc. holds a 61% interest in a limited liability company which owns the Tidewater Inn. During 2017 and 2016, approximately \$25 thousand and \$16 thousand in expenses were paid for rental and catering services.

**NOTE 24. CONTINGENCIES**

In the normal course of business, Shore Bancshares, Inc. and its subsidiaries may become involved in litigation arising from banking, financial, and other activities. Management, after consultation with legal counsel, does not anticipate that the future liability, if any, arising out of current proceedings will have a material effect on the Company's financial condition, operating results, or liquidity.

**NOTE 25. PARENT COMPANY FINANCIAL INFORMATION**

The following tables provide condensed financial information for Shore Bancshares, Inc. (Parent Company Only).

## Condensed Balance Sheets

December 31,

(Dollars in thousands)	2017	2016
Assets		
Cash	\$683	\$1,249
Investment securities available for sale, at fair value	1,127	11,846
Investment in subsidiaries	157,880	137,078
Premises and equipment, net	3,435	3,547
Other assets	2,209	3,160
Total assets	\$165,334	\$156,880
Liabilities		
Accrued interest payable	\$-	\$1

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Other liabilities	932	1,737
Short-term borrowings	666	-
Long-term debt	-	843
Total liabilities	1,598	2,581
Stockholders' equity		
Common stock	127	127
Additional paid in capital	65,256	64,201
Retained earnings	99,662	90,964
Accumulated other comprehensive loss	(1,309 )	(993 )
Total stockholders' equity	163,736	154,299
Total liabilities and stockholders' equity	\$165,334	\$156,880

## Condensed Statement of Income

For the Years Ended December 31,

(Dollars in thousands)	2017	2016	2015
Income			
Dividends from subsidiaries	\$1,000	\$1,230	\$1,045
Management and other fees from subsidiaries	7,811	8,960	8,723
Other income	94	278	228
Total income	8,905	10,468	9,996
Expenses			
Interest expense	36	46	61
Salaries and employee benefits	4,799	6,296	5,536
Occupancy and equipment expense	592	559	531
Other operating expenses	2,878	2,507	3,009
Total expenses	8,305	9,408	9,137
Income before income tax benefit and equity in undistributed net income of subsidiaries	600	1,060	859
Income tax benefit	(138 )	(58 )	(65 )
Income before equity in undistributed net income of subsidiaries	738	1,118	924
Equity in undistributed net income of subsidiaries	10,524	8,520	6,184
Net income	\$11,262	\$9,638	\$7,108

## Condensed Statements of Cash Flows

For the Years Ended December 31,

(Dollars in thousands)	2017	2016	2015
<b>Cash flows from operating activities:</b>			
Net income	\$11,262	\$9,638	\$7,108
<b>Adjustments to reconcile net income to cash provided by operating activities:</b>			
Equity in undistributed net income of subsidiaries	(10,524)	(8,520)	(6,184)
Depreciation and amortization	452	288	336
Stock-based compensation expense	1,055	334	283
Net decrease (increase) in other assets	843	(669 )	(1,108)
Net (decrease) increase in other liabilities	(806 )	533	328
Net cash provided by operating activities	2,282	1,604	763
<b>Cash flows from investing activities:</b>			
Proceeds from maturities and principal payments of investment securities available for sale	534	2,171	1,418
Purchases of securities	-	(2,032)	(4,054)
Purchases of premises and equipment	(148 )	(175 )	(672 )
Cash received from merged subsidiary	-	-	3,349
Payments for investments in and advances to subsidiary	(267 )	-	-
Net cash provided by (used in) investing activities	119	(36 )	41
<b>Cash flows from financing activities:</b>			
Increase in short-term borrowings	666	-	-
Repayment of long-term debt	(843 )	(500 )	(500 )
Proceeds from issuance of common stock	-	53	-
Common stock dividends paid	(2,790 )	(1,771)	(506 )
Net cash used in financing activities	(2,967 )	(2,218)	(1,006)
Net decrease in cash and cash equivalents	(566 )	(650 )	(202 )
Cash and cash equivalents at beginning of year	1,249	1,899	2,101
Cash and cash equivalents at end of year	\$683	\$1,249	\$1,899
<b>Supplemental cash flow information:</b>			
Transfer of available for sale securities to banking subsidiary	\$10,233	\$-	\$-

**NOTE 26. QUARTERLY FINANCIAL RESULTS (unaudited)**

The following table provides a summary of selected consolidated quarterly financial data for the three years ended December 31, 2017.

(In thousands, except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2017				
Interest income	\$10,447	\$11,449	\$12,937	\$12,968
Net interest income	9,933	10,900	12,326	12,369
Provision for credit losses	427	974	345	545
Income before income taxes	4,662	3,906	5,686	5,531
Net income	2,800	2,352	3,412	2,698
Basic earnings per common share	\$0.22	\$0.19	\$0.27	\$0.21
Diluted earnings per common share	\$0.22	\$0.19	\$0.27	\$0.21
Dividends paid per common share	\$0.05	\$0.05	\$0.05	\$0.07
2016				
Interest income	\$9,908	\$10,003	\$10,236	\$10,505
Net interest income	9,243	9,383	9,658	9,965
Provision for credit losses	450	375	605	418
Income before income taxes	3,995	3,684	3,843	4,377
Net income	2,460	2,272	2,411	2,495
Basic earnings per common share	\$0.19	\$0.18	\$0.19	\$0.20
Diluted earnings per common share	\$0.19	\$0.18	\$0.19	\$0.20
Dividends paid per common share	\$0.03	\$0.03	\$0.03	\$0.05
2015				
Interest income	\$9,445	\$9,542	\$9,837	\$10,047
Net interest income	8,539	8,683	9,010	9,293
Provision for credit losses	650	540	410	475
Income before income taxes	2,270	2,631	3,109	3,506
Net income	1,409	1,627	1,909	2,163
Basic earnings per common share	\$0.11	\$0.13	\$0.15	\$0.17
Diluted earnings per common share	\$0.11	\$0.13	\$0.15	\$0.17
Dividends paid per common share	\$-	\$-	\$0.02	\$0.02

Earnings per share are based on quarterly results and may not be additive to the annual earnings per share amounts.

**NOTE 27. SEGMENT REPORTING**

The Company operates two primary business segments: Community Banking and Insurance Products and Services. The Community Banking business provides services to consumers and small businesses in Maryland, Delaware and the Eastern Shore of Virginia through its 21-branch network. 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.

Selected financial information by business segments is included in the following table.

(Dollars in thousands)	Community Banking	Insurance Products and Services	Parent Company	Consolidated Total
2017				
Interest Income	\$47,721	\$ -	\$ 80	\$ 47,801
Interest Expense	(2,273 )	-	-	(2,273 )
Provision for credit losses	(2,291 )	-	-	(2,291 )
Noninterest income	8,377	9,388	(15 )	17,750
Noninterest expense	(25,570 )	(7,517 )	(8,115 )	(41,202 )
Net intersegment (expense) income	(6,973 )	(677 )	7,650	-
Income (loss) before taxes	18,991	1,194	(400 )	19,785
Income tax (expense) benefit	(9,127 )	466	138	(8,523 )
Net Income (loss)	\$9,864	\$ 1,660	\$(262 )	\$ 11,262
Total assets	\$ 1,376,777	\$ 11,063	\$ 6,020	\$ 1,393,860
2016				
Interest Income	\$40,400	\$ -	\$ 252	\$ 40,652
Interest Expense	(2,403 )	-	-	(2,403 )
Provision for credit losses	(1,848 )	-	-	(1,848 )
Noninterest income	7,935	8,710	-	16,645
Noninterest expense	(21,054 )	(6,890 )	(9,203 )	(37,147 )
Net intersegment (expense) income	(8,020 )	(761 )	8,781	-
Income (loss) before taxes	15,010	1,059	(170 )	15,899
Income tax (expense) benefit	(5,887 )	(432 )	58	(6,261 )
Net Income (loss)	\$9,123	\$ 627	\$(112 )	\$ 9,638
Total assets	\$ 1,132,861	\$ 9,596	\$ 17,814	\$ 1,160,271
2015				
Interest Income	\$38,652	\$ -	\$ 219	\$ 38,871
Interest Expense	(3,346 )	-	-	(3,346 )
Provision for credit losses	(2,075 )	-	-	(2,075 )
Noninterest income	7,135	8,297	(16 )	15,416
Noninterest expense	(21,480 )	(6,984 )	(8,886 )	(37,350 )
Net intersegment (expense) income	(7,718 )	(781 )	8,499	-
Income (loss) before taxes	11,168	532	(184 )	11,516
Income tax (expense) benefit	(4,274 )	(204 )	70	(4,408 )
Net Income (loss)	\$6,894	\$ 328	\$(114 )	\$ 7,108
Total assets	\$ 1,107,367	\$ 9,984	\$ 17,792	\$ 1,135,143



**PART IV**

**Item 15. Exhibits, Financial Statement Schedules.**

(a)(1), (2) and (c) Financial statements and schedules:

Reports of Independent Registered Public Accounting Firms

Consolidated Balance Sheets at December 31, 2017 and 2016

Consolidated Statements of Income — Years Ended December 31, 2017, 2016, and 2015

Consolidated Statements of Comprehensive Loss — Years Ended December 31, 2017, 2016, and 2015

Consolidated Statements of Changes in Stockholders' Equity — Years Ended December 31, 2017, 2016, and 2015

Consolidated Statements of Cash Flows — Years Ended December 31, 2017, 2016, and 2015

Notes to Consolidated Financial Statements for the years ended December 31, 2017, 2016, and 2015

(a)(3) and (b) Exhibits required to be filed by Item 601 of Regulation S-K:

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

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Shore Bancshares, Inc.

Date: April 9, 2018 By: /s/ Lloyd L. Beatty, Jr.  
Lloyd L. Beatty, Jr.  
*President and Chief Executive Officer*

**EXHIBIT LIST**

Exhibit No.	Description
3.1(i)	<u>Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000)</u>
3.1(ii)	<u>Articles Supplementary relating to the Fixed Rate Cumulative Perpetual Preferred Stock, Series A (incorporated by reference Exhibit 4.1 of the Company's Form 8-K filed on January 13, 2009)</u>
3.1(iii)	<u>Articles Supplementary relating to the reclassification of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, as common stock (incorporated by reference Exhibit 3.1(i) of the Company's Form 8-K filed on June 17, 2009)</u>
3.2(i)	<u>Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(i) of the Company's Form 10-K for the year ended December 31, 2010)</u>
3.2(ii)	<u>First Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(ii) of the Company's Form 10-K for the year ended December 31, 2010)</u>
3.2(iii)	<u>Second Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iii) of the Company's Form 10-K for the year ended December 31, 2010)</u>
3.2(iv)	<u>Third Amendment to Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2(iv) of the Company's Form 10-K for the year ended December 31, 2010)</u>
10.1	<u>Amended and Restated Employment Agreement, dated June 16, 2011, between the Company and W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 to the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011).</u>
10.2	<u>Employment Agreement, dated June 16, 2011, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.2 of the Company's Form 10-Q/A for the quarter ended June 30, 2011 filed on November 14, 2011)</u>
10.3	<u>Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007)</u>
10.4	<u>Summary of Compensation Arrangement between Centreville National Bank and F. Winfield Trice, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 13, 2007)</u>
10.5	<u>Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006)</u>

- 10.6 Shore Bancshares, Inc. Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 21, 2010)
- 10.7 Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)
- 10.8 Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006)
- 10.9 Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006)
- 10.10 Form of Amended and Restated Director Indexed Fee Continuation Plan Agreement between Centreville National Bank and Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K filed on January 7, 2009)

- 10.11 Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Freestate and Pierson (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006)
- 10.12 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.13 First Amendment to The Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan for the benefit of W. Moorhead Vermilye (incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K filed on January 7, 2009)
- 10.14 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005)
- 10.15 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319))
- 10.16 Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214))
- 10.17 Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006)
- 10.18 Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007)
- 10.19 Form of Performance Share/Restricted Stock Unit Award Agreement (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on July 8, 2015).
- 10.20 Amended and Restated Employment Agreement, dated September 21, 2015, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on September 25, 2015).
- 10.21 Amended and Restated Employment Agreement, dated February 16, 2017, between the Company and Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.21 to the Company's Form 10-K filed on March 16, 2017)
- 10.22 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)
- 10.23 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)
- 10.24 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)

- 10.25 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)
- 10.26 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)
- 21 Subsidiaries of the Company (included in the “BUSINESS—General” section of Item 1 of Part I of this Annual Report on Form 10-K)
- 23.1 Consent of Yount, Hyde & Barbour, P.C. (filed herewith)
- 23.2 Consent of Dixon Hughes Goodman LLP (filed herewith)
- 23.3 Consent of Stegman & Company (filed herewith)
- 31.1 Certifications of the PEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)

31.2      Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith)

32        Certification pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith)

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)