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 Incorporation or Organization)	(I.R.S. Employer Identification No.)

28969 Information Lane, Easton, Maryland 21601

(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 þ 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 þ 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 þ 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 þ 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 þ

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 þ

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

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.	/s/ Edward C. Allen
Lloyd L. Beatty, Jr.	Edward C. Allen
President and Chief Executive Officer	Senior Vice President and Chief Financial Officer
(Principal Executive Officer)	(Principal Financial Officer)

2

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

3

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

4

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

5

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and

Stockholders of Shore Bancshares, Inc.

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

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

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

/s/ Stegman & Company

Baltimore, Maryland

March 11, 2016

SHORE BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS

December 31,

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

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

7

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31,

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

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.

9

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 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.

10

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31,

(Dollars in thousands)	2017	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net Income	$11,262	$9,638	$7,108
Adjustments to reconcile net income to net cash provided by operating activities:			
Net accretion of acquisition accounting estimates	(506)	-	-
Provision for credit losses	2,291	1,848	2,075
Depreciation and amortization	1,649	2,449	2,434
Net amortization of securities	820	(22)	(99)
Stock-based compensation expense	1,055	334	283
Deferred income tax expense	4,476	5,717	3,874
(Gains) on sales and calls of securities	(5)	(30)	-
Losses on disposals of premises and equipment	22	-	18
Losses on sales and valuation adjustments on other real estate owned	207	363	171
(Gain) on sale of credit card portfolio	-	(198)	-
Net changes in:			
Accrued interest receivable	(827)	(218)	205
Other assets	(3,330)	(98)	(870)
Accrued interest payables	(9)	(32)	(66)
Other liabilities	331	(729)	(15)
Net cash provided by operating activities	17,436	19,022	15,118
CASH FLOWS FROM INVESTING ACTIVITES:			
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)

11

SHORE BANCSHARES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the Years Ended December 31,

CASH FLOWS FROM FINANCING ACTIVITIES:			
Net changes in:			
Noninterest-bearing deposits	32,185	31,890	35,872
Interest-bearing deposits	(39,263)	(9,864)	(9,412)
Short-term borrowings	18,531	(3,469)	1,864
Proceeds from the issuance of common stock	-	53	-
Common stock dividends paid	(2,790)	(1,771)	(506)
Net cash provided by financing activities	8,663	16,839	27,818
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(44,118)	2,127	(22,412)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	75,938	73,811	96,223
CASH AND CASH EQUIVALENTS AT END OF YEAR	$31,820	$75,938	$73,811
Supplemental cash flows information:			
Interest paid	$2,368	$2,434	$3,413
Income taxes paid	$3,900	$435	$518
Transfers from loans to other real estate owned	$95	$2,289	$2,773
Unrealized gain (loss) on securities available for sale	$(155)	$(1,664)	$119
Amortization of unrealized loss on securities transferred from available for sale to held to maturity	$30	$29	$76
Branch purchase:			
Tangible assets acquired (net of cash received)	$129,188	$-	$-
Identifiable intangible assets acquired	$3,954	$-	$-
Liabilities assumed	$212,463	$-	$-

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

SHORE BANCSHARES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

Nature of Operations

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

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements, and affect the reported amounts of revenues earned and expenses incurred during the reporting period. Actual results could differ from those estimates. Estimates that could change significantly relate to the determination of the allowance for loan losses, the determination of fair values related to impaired loans and other real estate owned, fair values initially assigned in an acquisition and subsequent evaluations of the related goodwill and intangible assets for impairment, and the valuation of deferred tax assets.

Investment Securities Available for Sale

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

Investment Securities Held to Maturity

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

Loans

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

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

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

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

Allowance for Credit Losses

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

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

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

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

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

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

Premises and Equipment

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

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

Goodwill and Other Intangible Assets

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

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

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

Other Real Estate Owned

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

Short-Term Borrowings

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

Income Taxes

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

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent on the generation of a sufficient level of future taxable income, recoverable taxes paid in prior years and tax planning strategies. The Company evaluates all positive and negative evidence before determining if a valuation allowance is deemed necessary regarding the realization of deferred tax assets.

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

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

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

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

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

Basic and Diluted Earnings Per Common Share

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

Transfers of Financial Assets

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

Cash and Cash Equivalents

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

Share-Based Compensation

The Company may grant share-based compensation to employees and non-employee directors in the form of restricted stock, restricted stock units and stock options. The fair value of restricted stock is determined based on the closing price of the Parent’s common stock on the date of grant. The Company recognizes compensation expense related to restricted stock on a straight-line basis over the vesting period for service-based awards, plus additional recognition of costs associated with accelerated vesting based on the projected attainment of Company performance measures. Restricted stock units (“RSUs”) are payable solely in cash which are accounted for as other liabilities in the consolidated statements of condition. The fair value of RSUs is initially valued based on the closing price of the Parent’s common stock on the date of grant and is amortized in the statement of income over the vesting period. The RSUs are subsequently remeasured in the same manner described above at the end of each reporting period until settlement. The fair value of stock options is estimated at the date of grant using the Black-Scholes option pricing model and related assumptions. The Company uses historical data to predict option exercise and employee termination behavior. Expected volatilities are based on the historical volatility of the Parent’s common stock. The expected term of options granted is derived from actual historical exercise activity and represents the period of time that options granted are expected to be outstanding. The risk-free rate is derived from the U.S. Treasury yield curve in effect at the time of grant based on the expected life of the option. The dividend yield is equal to the dividend yield of the Parent’s common stock at the time of grant. The amortization of the expense related to stock options reflects estimated forfeitures, adjusted for actual forfeiture experience. Amortization expense related to stock options is recorded in the statements of income as a component of salaries and benefits for employees and as a component of other noninterest expense for non-employee directors, with a corresponding increase to capital surplus in shareholders’ equity. As the expense related to stock options is recognized, a deferred tax asset is established that represents an estimate of future income tax deductions from the release of restrictions or the exercise of stock options. See Note 13 for a further discussion.

Fair Value

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

Advertising Costs

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

Comprehensive Income

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

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

Recent Accounting Standards

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

ASU No. 2016-01, *"Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities"*. This ASU, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. ASU 2016-01 will be effective for us on January 1, 2018 and is not expected to have a significant impact on our financial statements. The Company is currently evaluating methods of measuring fair value of its loan portfolio using an exit price notion as noted in (iv) above. In addition, the Company has hired a third-party valuation expert to aid in the transition to the fair value guidance.

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

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

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

ASU No. 2016-15, *"Classification of Certain Cash Receipts and Cash Payments."* Current GAAP is unclear or does not include specific guidance on how to classify certain transactions in the statement of cash flows. This ASU is intended to reduce diversity in practice in how eight particular transactions are classified in the statement of cash flows. ASU No. 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted, provided that all of the amendments are adopted in the same period. Entities will be required to apply the guidance retrospectively. If it is impracticable to apply the guidance retrospectively for an issue, the amendments related to that issue would be applied prospectively. We adopted the amendments in this ASU effective January 1, 2017. The adoption of ASU No. 2016-15 did not have a material impact on our consolidated financial statements.

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

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

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

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

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

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

NOTE 2. BUSINESS COMBINATION

Northwest Bank Branch Acquisition

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

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

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

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

Performing loans acquired	$ 125,131	125,131	2,269	$ 122,862

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	152,198	157	1,390	150,965
Equity	666	-	8	658
Total	$ 198,670	$ 180	$ 1,895	$ 196,955
December 31, 2016				
U.S. Government agencies	$ 34,320	$ 56	$ 58	$ 34,318
Mortgage-backed	130,490	263	1,809	128,944
Equity	652	-	12	640
Total	$ 165,462	$ 319	$ 1,879	$ 163,902
Held-to-maturity securities:				
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.

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	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

	Less than 12 Months		More than 12 Months		Total	
(Dollars in thousands)	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

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.

	Available for sale		Held to maturity	
	Amortized		Amortized	
(Dollars in thousands)	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.

23

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.

	December 31, 2017		December 31, 2016	
(Dollars in thousands)	Amortized Cost	Fair Value	Amortized 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	1,960	2,045	2,561	2,208	202	8,976

impairment	
Total loans	10

provided that the foregoing shall not apply to adjustments or substitutions in accordance with Section 5.

Notwithstanding anything to the contrary contained in this Section 12, no termination, amendment or modification of the Plan may, without the consent of the Participant or the transferee of such Participant's Option or Other Stock-Based Award, alter or impair the rights and obligations arising under any then outstanding Option or Other Stock-Based Award.

13. Non-Exclusivity

Subject to the express provisions contained in the HSI Agreement, neither the adoption of the Plan by the Board nor the submission of the Plan to the stockholders of the Company for approval shall be construed as creating any limitations on the power of the Board to adopt such other incentive arrangements as it may deem desirable, including, without limitation, the granting or issuance of stock options, Shares and/or other incentives otherwise than under the Plan, and such arrangements may be either generally applicable or limited in application.

14. Use of Proceeds

The proceeds of the sale of Shares subject to Options or Other Stock-Based Awards under the Plan are to be added to the general funds of the Company and used for its general corporate purposes as the Board shall determine.

15. General Provisions

(a) *Right to Terminate Services*. Neither the adoption of the Plan nor the grant of Options or Other Stock-Based Awards shall impose any obligations on the Company to retain any Participant as a director nor shall it impose any obligation on the part of any Participant to remain a director.

(b) *Purchase for Investment.* If the Board determines that the law so requires, the holder of an Option or Other Stock-Based Award granted hereunder shall, upon any exercise or conversion thereof, execute and deliver to the Company a written statement, in form satisfactory to the Company, representing and warranting that such Participant is purchasing or accepting the Shares then acquired for such Participant's own account and not with a view to the resale or distribution thereof, that any subsequent offer for sale or sale of any such Shares shall be made either pursuant to (i) a registration statement on in appropriate form under the Securities Act, which registration statement shall have become effective and shall be current with respect to the Shares being offered and sold, or (ii) a specific exemption from the registration requirements of the Securities Act, and that in claiming such exemption the holder will, prior to any offer for sale or sale of such Shares, obtain a favorable written opinion, satisfactory in form and substance to the Company, from counsel approved by the Company as to the availability of such exception.

(c) *Trusts, etc.* Nothing contained in the Plan and no action taken pursuant to the Plan (including, without limitation, the grant of any Option or Other Stock-Based Award thereunder) shall create or be construed to create a trust of any kind, or a fiduciary relationship, between the Company and any Participant or the executor, administrator or other personal representative or designated beneficiary of such Participant, or any other persons. Any reserves that may be established by the Company in connection with the Plan shall continue to be part of the general funds of the Company, and no individual or entity other than the Company shall have any interest in such funds until paid to a Participant. If and to the extent that any Participant or such Participant's executor, administrator, or other personal representative, as the case may be, acquires a right to receive any payment from the Company pursuant to the Plan, such right shall be no greater than the right of an unsecured general creditor of the Company.

(d) *Notices.* Each Participant shall be responsible for furnishing the Committee with the current and proper address for the mailing to such Participant of notices and the delivery to such Participant of agreements, Shares and payments. Any notices required or permitted to be given shall be deemed given if directed to the person to whom addressed at such address and mailed by regular United States mail, first class and prepaid. If any item mailed to such address is returned as undeliverable to the addressee, mailing will be suspended until the Participant furnishes the proper address.

(e) *Severability of Provisions*. If any provisions of the Plan shall be held invalid or unenforceable, such invalidity or unenforceability shall not affect any other provisions of the Plan, and the Plan shall be construed and enforced as if such provisions had not been included.

(f) *Payment to Minors, Etc.* Any benefit payable to or for the benefit of a minor, an incompetent person or other person incapable of receipting therefor shall be deemed paid when paid to such person's guardian or to the party providing or reasonably appearing to provide for the care of such person, and such payment shall fully discharge the Committee, the Company and their employees, agents and representatives with respect thereto.

(g) *Readings and Captions*. The headings and captions herein are provided for reference and convenience only. They shall not be considered part of the Plan and shall not be employed in the construction of the Plan.

16. Issuance of Stock Certificates; Legends and Payment of Expenses

(a) *Stock Certificates*. Upon any exercise of an Option and payment of the exercise price as provided in such Option, or upon conversion of an Other Stock-Based Award, a certificate or certificates for the Shares as to which such Option has been exercised or Other Stock-Based Award has been converted, shall be issued by the Company in the name of the person or persons exercising such Option or converting such Other

Stock-Based Award and shall be delivered to or upon the order of such person or persons.

(b) *Legends.* Certificates for Shares issued upon exercise of an Option or conversion of an Other Stock-Based Award shall bear such legend or legends as the Committee, in its discretion, determines to be necessary or appropriate to prevent a violation of, or to perfect an exemption from, the registration requirements of the Securities Act, or to implement the provisions of any agreements between the Company and the Participant with respect to such Shares.

(c) *Payment of Expenses*. The Company shall pay all issue or transfer taxes with respect to the issuance or transfer of Shares, as well as all fees and expenses necessarily incurred by the Company in connection with such issuance or transfer and with the administration of the Plan.

17. Listing of Shares and Related Matters

If at any time the Board shall determine in its sole discretion that the listing, registration or qualification of the Shares covered by the Plan upon any national securities exchange or under any state or federal law, or the consent or approval of any governmental regulatory body, is necessary or desirable as a condition of, or in connection with, the award or sale of Shares under the Plan, no Shares will be delivered unless and until such listing, registration, qualification, consent or approval shall have been effected or obtained, or otherwise provided for, free of any conditions not acceptable to the Board.

18. Withholding Taxes

Where a Participant or other person is entitled to receive Shares pursuant to the exercise of an Option or the conversion of an Other Stock-Based Award, the Company shall have the right to require the Participant or such other person to pay to the Company the amount of any taxes which the Company may be required to withhold before delivery to such Participant or other person of cash or a certificate or certificates representing such Shares.

12

AMENDMENT

TO THE

HENRY SCHEIN, INC.

1996 NON-EMPLOYEE DIRECTOR STOCK INCENTIVE PLAN

WHEREAS, Henry Schein, Inc. (the "Company") maintains the Henry Schein, Inc. 1996 Non-Employee Director Stock Incentive Plan, as amended (the "Plan");

WHEREAS, pursuant to Section 12 of the Plan, the Board of Directors of the Company (the "Board") reserved the right to amend the Plan; and

WHEREAS, the Board desires to amend the Plan.

NOW, THEREFORE, the Plan is amended, effective as of April 1, 2004, subject to stockholder approval (other than with respect to Section 3 below, which is not subject to stockholder approval) as follows:

1. Section 3 of the Plan is amended by adding the following new sentence to the end thereof: "Notwithstanding the foregoing, no Option or Other Stock-Based Award shall be granted under the Plan on or after March 22, 2011, but Options or Other Stock-Based Awards previously granted may extend beyond that date."

2. The first sentence of Section 5(b) of the Plan is amended by substituting the number "400,000" in lieu of "200,000" where it appears therein.

3.

Section 5(b) of the Plan is amended by adding the following new sentence to the end thereof: "Subject to adjustment as provided in this Section 5, the maximum aggregate number of Shares that are available for the grant of Other Stock-Based Awards under the Plan shall be 140,000 Shares of Common Stock."

IN WITNESS WHEREOF, the Company has caused this amendment to be executed this 21st day of April, 2004.

HENRY SCHEIN, INC.

By: /s/ MICHAEL ETTINGER

Title: Vice President, General Counsel and Secretary

Exhibit D

Henry Schein, Inc. 2004 Employee Stock Purchase Plan

HENRY SCHEIN, INC.

2004 EMPLOYEE STOCK PURCHASE PLAN

HENRY SCHEIN, INC.

2004 EMPLOYEE STOCK PURCHASE PLAN

1. Purpose.

The purpose of the Plan is to provide employees of the Company and its Designated Subsidiaries and Designated Parent with an opportunity to purchase Common Stock of the Company through accumulated payroll deductions. It is the intention of the Company that the Plan qualify as an "employee stock purchase plan" within the meaning of Section 423 of the Code and the provisions of the Plan shall be construed in a manner consistent with the requirements of such section of the Code. The Plan shall be effective on January 1, 2005, subject to approval of the holders of the Company's Common Stock within twelve (12) months before or after the date the Plan is adopted by the Board.

2. Definitions.

(a) "Agent" shall mean the agent appointed by the Committee pursuant to Section 11(b) hereof.

(b) "Board" shall mean the Board of Directors of the Company.

(c) "Code" shall mean the Internal Revenue Code of 1986, as amended.

(d) "Committee" shall mean the Compensation Committee of the Board or such other committee or subcommittee appointed from time to time by the Board. To the extent that no Committee exists which has the authority to administer the Plan, the functions of the Committee shall be exercised by the Board.

(e) "Common Stock" shall mean shares of the Company's common stock, par value $.01 per share.

(f) "Company" shall mean Henry Schein, Inc., a Delaware corporation or any successor corporation.

(g) "Compensation" shall mean the total cash compensation paid during an Offering Period by the Company, any Designated Subsidiary or Designated

Parent or any affiliate of the Company to an Employee, including overtime, commissions and bonuses, as reported by the Company, any Designated Subsidiary or Designated Parent or any affiliate of the Company for federal income tax purposes, and including an Employee's portion of salary deferral contributions pursuant to Section 401(k) of the Code and any amount excludable pursuant to Section 125 or 132(f) of the Code. Compensation shall not include any contributions by the Company or any of its affiliates to, or benefits paid under, this Plan or under any other pension, profit-sharing, fringe benefit, group insurance or other employee welfare plan heretofore or hereafter adopted or any deferred compensation arrangement. For purposes of this Section, affiliate shall mean any entity required to be aggregated with the Company under Section 414 (b), (c), (m) or (o) of the Code.

(h) "Designated Parent" shall mean the Parent Corporation of the Company if so specifically designated as eligible to participate in the Plan by the Board in its sole discretion.

(i) "Designated Subsidiaries" shall mean each Subsidiary Corporation of the Company on the effective date of the Plan and future Subsidiary Corporations which are not specifically excluded from participation by the Board from time to time in its sole discretion. Notwithstanding the foregoing, after the effective date of the Plan the term "Designated Subsidiaries" shall not include future Subsidiary Corporations located in Foreign Jurisdictions, unless the Board specifically designates any such Subsidiary Corporation as a Designated Subsidiary.

(j) "Disability" or "Disabled" shall mean a permanent and total disability as defined under Section 22(e)(3) of the Code.

(k) "Employee" shall mean any person, including an officer, who is regularly and continuously employed by the Company, a Designated Subsidiary or a Designated Parent.

(l) "Employer" shall mean, with respect to any Employee, the Company, a Designated Subsidiary or a Designated Parent by which the Employee is employed.

(m) "Exchange Act" shall mean the Securities Exchange Act of 1934, as amended.

(n) "Exercise Date" shall mean the last business day of each Offering Period in which payroll deductions are made under the Plan.

(o) "Fair Market Value" shall mean, unless otherwise required by any applicable provision of the Code or any regulations issued thereunder, as of any date, the last sales price reported for the Common Stock on the applicable date (i) as reported by the principal national securities exchange in the United States on which it is then traded or The Nasdaq Stock Market, Inc. or (ii) if not traded on any such national securities exchange or The Nasdaq Stock Market, Inc., as quoted on an automated quotation system sponsored by the National Association of Securities Dealers, Inc. If the Common Stock is not readily tradable on a national securities exchange, The Nasdaq Stock Market, Inc. or any system sponsored by the National Association of Securities Dealers, Inc. its Fair Market Value shall be set in good faith by the Committee.

(p) "Foreign Jurisdiction" shall mean any jurisdiction outside of the United States including, without limitation, countries, states, provinces and localities.

(q) "Leave of Absence" shall mean a leave of absence determined in accordance with the personnel policies of a Participant's Employer.

(r) "Offering Date" shall mean January 1 and July 1 or such other dates designated by the Committee in its sole discretion.

(s) "Offering Period" shall mean each semi-annual period during each calendar year during the effectiveness of the Plan, commencing on each Offering Date, provided that the Committee shall have the authority to change the duration of Offering Periods, in its sole discretion.

(t) "Option" shall mean an option to purchase Common Stock of the Company.

(u) "Parent Corporation" shall mean any corporation (other than the Company) in an unbroken chain of corporations ending with the Company if, at the time of granting an Option, each of the corporations other than the employer corporation owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

(v) "Participant" shall mean an Employee who participates in the Plan.

(w) "Plan" shall mean this Henry Schein, Inc. 2004 Employee Stock Purchase Plan, as amended from time to time.

(x) "Rule 16b-3" shall mean Rule 16b-3 under Section 16(b) of the Exchange Act as then in effect or any successor provisions.

(y) "Subsidiary Corporation" shall mean any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company at the time of granting an Option, each of the corporations other than the last corporation in the unbroken chain owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

3. Eligibility.

(a) Subject to the requirements of Section 4(b) hereof, any person who is (i) an Employee as of an Offering Date and (ii) who customarily works more than twenty (20) hours per week for an

Employer and more than five (5) months per year for an Employer shall be eligible to participate in the Plan and be granted an Option for the Offering Period commencing on such Offering Date.

(b) Notwithstanding any provisions of the Plan to the contrary, no Employee shall be granted an Option under the Plan:

(i) if, immediately after the grant, such Employee (or any other person whose stock would be attributed to such Employee pursuant to Section 424(d) of the Code) would own stock and/or hold outstanding Options to purchase stock possessing five percent (5%) or more of the total combined voting power or value of all classes of stock of the Company or of any Subsidiary Corporation or Parent Corporation; or

(ii) which permits such Employee's right to purchase stock under all employee stock purchase plans (as described in Section 423 of the Code) of the Company and any Subsidiary Corporation or Parent Corporation to accrue at a rate which exceeds twenty-five thousand dollars ($25,000) of fair market value of such stock (determined at the time such option is granted) for any calendar year in which such option is outstanding at any time.

4. Grant of Option; Participation.

(a) On each Offering Date, the Company shall commence an offer by granting each Employee eligible pursuant to Section 3 hereunder, an Option to purchase Common Stock, subject to the limitations set forth in Sections 3(b) and 10 hereof. The Committee shall specify the terms and conditions for each such offer, including the number of shares of Common Stock that may be purchased thereunder.

(b) Each eligible Employee may elect to become a Participant in the Plan with respect to an Offering Period, only by filing an agreement with the Employer authorizing payroll deductions (as set forth in Section 5 hereof).

(c) The Option price per share of the Common Stock subject to an offering shall be determined by the Board, in its sole discretion, and shall remain in effect unless modified at least thirty (30) days prior to the applicable Offering Date, but in no event shall be less than the lesser of: (i) eighty-five percent (85%) of the Fair Market Value of a share of Common Stock on the first business day of the Offering Period or (ii) eighty-five (85%) of the Fair Market Value of a share of Common Stock on the Exercise Date.

5. Payroll Deductions.

(a) At least fourteen (14) days (or such shorter period designated by the Committee) prior to each Offering Date, a Participant may, in the manner prescribed by forms approved by the Committee, authorize payroll deductions up to a limit specified by the Committee, which may be expressed as a dollar amount or a percentage of a Participant's Compensation (as determined by the Committee), provided that in no event shall such deductions exceed ten percent (10%) of a Participant's Compensation during the Offering Period or the limit set forth in Section 3(b)(ii) above. A Participant may increase or decrease such payroll deductions (subject to the limits provided in the prior sentence) prior to the beginning of any subsequent Offering Period, upon fourteen (14) days' (or such shorter period designated by the Committee) prior written notice to the Committee. A Participant may terminate a payroll deduction authorization at any time, upon fourteen (14) days' (or such shorter period designated by the Committee) prior written notice to the Committee. An authorization shall remain in effect until modified or terminated by the Participant or until the percentage used to determine the Option price (as determined pursuant to Section 4(c) above) is effectively increased.

(b) All payroll deductions made by a Participant shall be credited to such Participant's account under the Plan. A Participant may not make any additional payments into such account.

(c) In the event a Participant makes a hardship withdrawal of employee deferral contributions under a 401(k) profit sharing plan of the Company, a Designated Subsidiary, or a Designated Parent or an affiliate or any other plan qualified under Section 401(a) of the Code that contains a Code Section 401(k) feature, such Participant's payroll deductions and the purchase of Common Stock under the Plan shall be suspended until the first payroll period following the Offering Date commencing after the six (6) month period (or such other time period required under Section 401(k) of the Code) after such hardship withdrawal. If a Participant who elects a hardship withdrawal under such a 401(k) profit sharing plan or such other plan has a cash balance accumulated in his or her account at the time of withdrawal that has not already been applied to purchase Common Stock, such cash balance shall be returned to the Participant as soon as administratively practicable.

6.

Exercise of Option.

(a) Unless a Participant withdraws from the Plan as provided in Section 8 hereof, such Participant's election to purchase Common Stock shall be exercised automatically on the Exercise Date, and the maximum number of whole and/or fractional shares of Common Stock subject to such Option shall be purchased for such Participant at the applicable Option price (determined in accordance with Section 4(c)) with the accumulated payroll deductions in such Participant's account. If all or any portion of the shares of Common Stock cannot reasonably be purchased on the Exercise Date because of unavailability or any other reason (as determined in the sole discretion of the Committee), such purchase shall be made as soon thereafter as practicable. In no event shall certificates for any fractional shares be issued under the Plan.

(b) Common Stock purchased upon exercise of an Option hereunder shall be credited to the Participant's account under the Plan and shall be deemed to be transferred to the Participant on the Exercise Date and, except as otherwise provided herein, the Participant shall have all rights of a stockholder with respect to such shares, including, without limitation, the right to receive dividends on the shares and the right to vote or tender such shares.

7. Delivery of Common Stock.

(a) Certificates for whole shares of Common Stock shall not be issued to Participants unless and until requested or as otherwise provided pursuant to Section 8. Such certificates shall be issued as soon as administratively practicable following the Participant's request for issuance. If a Participant requests certificates for whole shares of Common Stock, any fractional shares of Common Stock shall remain in the Participant's account during his or her employment, unless he or she requests cash in lieu of the fractional shares. A fee fixed by the Plan's Agent or transfer agent, as the case may be, may be charged to the Participant for the issuance of certificates of Common Stock and for the replacement of lost certificates. Certificates for a fractional share of Common Stock shall not be issued under any circumstance.

(b) A Participant may request the Agent to sell all or a portion of shares of Common Stock for which certificates have not been issued and receive cash for such shares, subject to any brokerage fees or commissions.

8. Withdrawals; Termination of Employment; Disability or Leave of Absence Prior to Termination of Employment.

(a) A Participant may withdraw all, but not less than all, the payroll deductions credited to such Participant's account (that have not been used to purchase Common Stock) under the Plan at any time prior to the Exercise Date by giving fourteen (14) days' (or such shorter period designated by the Committee) prior written notice to the Committee. All such payroll deductions credited to such Participant's account shall be paid to such Participant (without interest) promptly after receipt of such Participant's written notice of withdrawal and such Participant's Option for the Offering Period in which the withdrawal occurs shall be automatically terminated. No further payroll deductions for the

4

purchase of Common Stock shall be made for such Participant during the Offering Period in which a withdrawal occurs. A Participant's withdrawal from an offering shall not have any effect upon such Participant's eligibility to participate in a subsequent offering or in any similar plan which may hereafter be adopted by the Company.

(b) If a Participant retires or terminates his or her employment with the Company, any Subsidiary Corporation and any Parent Corporation for any reason other than death, the payroll deductions credited to such Participant's account (that have not been used to purchase Common Stock) shall be returned or distributed to the Participant (without interest) as soon as practicable following the Participant's retirement or other termination of employment. The Participant shall elect, within the sixty (60) day period following the Participant's retirement or other termination of employment with the Company, any Subsidiary Corporation and any Parent Corporation: (i) to receive certificates for all of the whole shares of Common Stock and cash in lieu of any fractional shares of Common Stock credited to the Participant's account under the Plan, (ii) to have certificates for all shares of Common Stock (including fractional shares) credited to the Participant's account under the Plan transferred to an individual brokerage account established by the Agent for the benefit of the Participant or for the benefit of the Participant and his or her spouse as joint tenants with rights of survivorship, or (iii) a combination of (i) and (ii). If the Participant fails to timely make such election, the Participant shall receive certificates for all of the whole shares of Common Stock and cash in lieu of any fractional shares of Common Stock credited to the Participant's account under the Plan. A fee fixed by the Plan's Agent may be charged to the Participant for the issuance of certificates of Common Stock.

(c) In the event of the Participant's death, the Participant's Option shall be exercised in accordance with the terms of the Plan such that the payroll deductions credited to such Participant's account after the Offering Date (whether before or immediately following the Participant's death) shall be used to purchase Common Stock in accordance with the terms of the Plan. The Participant's beneficiary shall elect, within the sixty (60) day period following the Exercise Date following the Participant's death, (i) to receive certificates for all of the whole shares of Common Stock and cash in lieu of any fractional shares of Common Stock credited to the Participant's account under the Plan, (ii) to have certificates for all shares of Common Stock (including fractional shares) credited to the Participant's account under the Plan transferred to an individual brokerage account established by the Agent for the benefit of the Participant's beneficiary, or (iii) a combination of (i) and (ii). If the Participant's beneficiary fails to timely make such election, the Participant's beneficiary shall receive certificates for all of the whole shares of Common Stock and cash in lieu of any fractional shares of Common Stock credited to the Participant's account under the Plan. A fee fixed by the Plan's Agent may be charged to the Participant's beneficiary for the issuance of certificates of Common Stock.

(d) In the event of a Participant's Disability or Leave of Absence, payroll deductions shall only be taken from Compensation that is due and owing to the Participant. To the extent that any cash balance has accumulated in the Participant's account, such balance shall be used to purchase Common Stock on the Exercise Date. With respect to a Participant who becomes ineligible to participate due to a Disability or Leave of Absence, Common Stock held in such Participant's account shall continue to be held in the Participant's account unless he or she elects otherwise under Section 7(a). In the event that such individual's Disability or Leave of Absence ends and such individual returns to work as an Employee and satisfies the eligibility conditions under Section 3, payroll deductions shall resume automatically in accordance with his or her most recent payroll deduction authorization form in effect prior to the Disability or Leave of Absence, unless he or she elects otherwise. Section 8(b) shall apply to any termination of employment with the Company, any Subsidiary Corporation and any Parent Corporation following a Participant's Disability or Leave of Absence.

5

9. Dividends and Interest.

(a) Cash dividends, if any, on Common Stock acquired pursuant to the exercise of an Option granted under the Plan will be automatically paid by check directly to the Participant by the Company, or if applicable, the transfer agent. Dividends paid in property other than cash or Common Stock shall be distributed to Participants as soon as practicable.

(b) No interest shall accrue on or be payable with respect to the payroll deductions of a Participant in the Plan.

10. Stock.

(a) The maximum number of shares of Common Stock that shall be reserved for sale under the Plan shall be 750,000 subject to adjustment as provided in Section 16 hereof. If the total number of Common Stock that would otherwise be subject to Options granted pursuant to Section 4(a) hereof on an Offering Date exceeds the number of shares of Common Stock then available under the Plan (after deduction of all shares for which Options have been exercised or are then outstanding), the Committee shall make a pro rata reduction and allocation of the shares of Common Stock remaining available for Options in as uniform a manner as shall be practicable and as it shall determine to be equitable. In such event, the Committee shall give written notice to each Participant of such reduction of the number of Option shares affected thereby and shall similarly reduce the rate of payroll deductions, if necessary. Purchases of Common Stock under the Plan shall be made by the Agent on the open market, or in the sole discretion of the Committee, may be made by the Company's delivery of treasury shares or newly-issued and authorized shares to the Plan, upon such terms as the Committee may approve.

(b) Common Stock to be delivered to a Participant under the Plan shall be registered solely in the name of the Participant or, at the election of the Participant, in the name of the Participant and his or her spouse as joint tenants with rights of survivorship.

11.

Administration.

(a) The Plan shall be administered by the Committee, and the Committee may delegate its duties and responsibilities hereunder, as determined by the Committee in its sole discretion. The Committee shall have full power and authority, subject to the provisions of the Plan, to grant Options to Participants, to promulgate such rules and regulations as it deems necessary for the proper administration of the Plan, to interpret the provisions and supervise the administration of the Plan, and to take all action in connection therewith or in relation thereto as it deems necessary or advisable. The Committee may adopt special guidelines and provisions for persons who are residing in, or subject to the laws of, Foreign Jurisdictions to comply with applicable tax, securities and other applicable laws. All interpretations and determinations of the Committee shall be made in its sole and absolute discretion based on the Plan document and shall be final, conclusive and binding on all parties.

(b) The Committee may employ such legal counsel, consultants, brokers and agents as it may deem desirable for the administration of the Plan and may rely upon any opinion received from any such counsel or consultant and any computation received from any such consultant, broker or agent. The Committee may, in its sole discretion, designate an Agent to administer the Plan, purchase and sell Common Stock in accordance with the Plan, keep records, send statements of account to Participants and to perform other duties relating to the Plan, as the Committee may request from time to time. The Agent shall serve as custodian for purposes of the Plan and, unless otherwise requested by the Participant, Common Stock purchased under the Plan shall be held by and in the name of, or in the name of a nominee of, the custodian for the benefit of each Participant, who shall thereafter be a beneficial stockholder of the Company. The Committee may adopt, amend or repeal any guidelines or requirements necessary for the custody and delivery of the Common Stock, including, without limitation, guidelines regarding the imposition of reasonable fees in certain circumstances.

(c) The Company shall, to the fullest extent permitted by law and the Certificate of Incorporation and By-laws of the Company and, to the extent not covered by insurance, indemnify each director, officer or employee of the Employer (including the heirs, executors, administrators and other personal representatives of such person) and each member of the Committee against all expenses, costs, liabilities and losses (including attorneys' fees, judgments, fines, excise taxes or penalties, and amounts paid or to be paid in settlement) actually and reasonably incurred by such person in connection with any threatened, pending or actual suit, action or proceeding (whether civil, criminal, administrative or investigative in nature or otherwise) in which such person may be involved by reason of the fact that he or she is or was serving this Plan in any capacity at the request of the Employer, the Committee or the Board, except in instances where any such person engages in fraud. Such right of indemnification shall include the right to be paid by the Company for expenses incurred or reasonably anticipated to be incurred in defending any such suit, action or proceeding in advance of its disposition; provided, however, the payment of expenses in advance of the settlement or final disposition of a suit, action or proceeding, shall be made only to the extent permitted by applicable law, and upon delivery to the Company of an undertaking by or on behalf of such person to repay all amounts so advanced if it is ultimately determined that such person is not entitled to be indemnified hereunder. Such indemnification shall be in addition to any rights of indemnification the person may have as a director, officer or employee or under the Certificate of Incorporation of the Company or the By-Laws of the Company. Expenses incurred by the Committee or the Board in the engagement of any such counsel, consultant or agent shall be paid by the Company.

(d) Participants shall be fully responsible for (i) any brokerage fees and commissions charged for the sale of Common Stock, (ii) any fees for certificates of Common Stock and (iii) any taxes owed by them as a result of participation in the Plan.

12. Designation of Beneficiary.

A Participant may file, on forms supplied by and delivered to the Committee, a written designation of a beneficiary who is to receive any Common Stock and cash remaining in such Participant's account under the Plan in the event of the Participant's death. Such designation of beneficiary may be changed by the Participant at any time by written notice. If a Participant is married on the date of his death and no beneficiary had been designated by the Participant prior to his death, the Participant's spouse shall be his beneficiary. If a Participant is not married on the date of his death and no beneficiary had been designated by the Participant prior to his death, the Participant's beneficiary shall be his estate.

13. Transferability.

(a) Neither payroll deductions credited to a Participant's account nor any rights with regard to the exercise of an Option or to receive Common Stock under the Plan may be assigned, transferred, pledged or otherwise disposed of in an way (other than by will, the laws of descent and distribution or as provided in Section 10(b) or 12 hereof) by the Participant. Any such attempt at assignment, transfer, pledge or other disposition shall be without effect, except that the Company may treat such act as an election to withdraw funds in accordance with Section 8 hereof.

(b) All rights of a Participant granted under this Plan, including, but not limited to, the grant of an Option, the right to exercise an Option and the ability to authorize payroll deductions shall relate solely to a Participant, except as otherwise provided in Section 8(c) hereof.

14. Use of Funds.

All payroll deductions received or held by the Company under the Plan may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions.

15. Reports.

Individual accounts shall be maintained for each Participant in the Plan. Statements of account shall be given to Participants at such times prescribed by the Committee; such statements shall set forth the amount of payroll deductions, the per share exercise price of an Option, the number of shares of Common Stock purchased, the aggregate shares in the Participant's account and the remaining cash balance, if any.

16. Effect of Certain Changes.

(a) In the event of any increase, reduction, or change or exchange of Common Stock for a different number or kind of shares or other securities of the Company by reason of a reclassification, recapitalization, merger, consolidation, reorganization, stock dividend, stock split or reverse stock split, combination or exchange of shares, repurchase of shares, change in corporate structure or otherwise, or the distribution of an extraordinary dividend, the Committee shall conclusively determine the appropriate equitable adjustments, if any, to be made under the Plan, including, without limitation, adjustments to the number of shares of Common Stock that have been authorized for issuance under the Plan but have not yet been placed under Option, as well as the per share exercise price of an Option granted under the Plan that has not yet been exercised.

(b) In the event of the complete liquidation of the Company or of a reorganization, consolidation or merger in which the Company is not the surviving Corporation, any Option shall continue in full force and effect unless either (i) the Committee modifies such Option so that it is fully exercisable with respect to all of the Common Stock subject thereto prior to the effective date of such transaction or (ii) the surviving corporation issues or assumes a stock option as contemplated under Section 424(a) of the Code.

17. Amendment or Termination.

The Company, by action of the Board (or a duly authorized committee thereof) or the Committee, may at any time terminate, amend or freeze the Plan. No such termination shall adversely affect Options previously granted and no amendment may make any change in any Option theretofore granted that adversely affects the rights of any Participant. No amendment shall be effective unless approved by the stockholders of the Company if stockholder approval of such amendment is required to comply with Section 423 of the Code or to comply with any other applicable law, regulation or stock exchange rule. Upon termination of the Plan, the Company shall return or distribute the payroll deductions credited to a Participant's account (that have not been used to purchase Common Stock) and shall distribute or credit shares of Common Stock credited to a Participant's account in accordance with Section 8(b) hereof. Upon the freezing of the Plan, any payroll deductions credited to a Participant's account (that have not been used to purchase Common Stock) shall be used to purchase Common Stock in accordance with Section 6, substituting the term Exercise Date with the effective date of the freezing of the Plan.

18.

Notices.

All notices or other communications by a Participant to the Company or the Committee under, or in connection with, the Plan shall be deemed to have been duly given when received in the form specified by the Company or Committee at the location, or by the person, designated for the receipt thereof. Each Participant shall be responsible for furnishing the Committee with the current and proper address for the mailing of notices and the delivery of other information. Any notices or communications by the Company to a Participant shall be deemed given if directed to such address and mailed by regular United States mail, first-class and prepaid. If any item mailed to such address is returned as undeliverable to the addressee, mailing shall be suspended until the Participant furnishes the proper address.

19.

Regulations and Other Approvals; Governing Law.

(a) This Plan and the rights of all persons claiming hereunder shall be construed and determined in accordance with the laws of the State of Delaware without giving effect to the choice of law principles thereof, except to the extent that such law is preempted by federal law.

(b) The obligation of the Company to sell or deliver Common Stock with respect to Options granted under the Plan shall be subject to all applicable laws, rules and regulations, including all applicable federal and state securities laws, and the obtaining of all such approvals by governmental agencies as may be deemed necessary or appropriate by the Committee.

(c) To the extent required, the Plan is intended to comply with Rule 16b-3 and the Committee shall interpret and administer the provisions of the Plan in a manner consistent therewith. Any provisions inconsistent with Rule 16b-3 shall be inoperative and shall not affect the validity of the Plan. The Committee may establish and adopt written administrative guidelines, designed to facilitate compliance with Section 16(b) of the Exchange Act and Rule 16b-3, as it may deem necessary or proper for the administration and operation of the Plan and the transaction of business thereunder.

20.

Withholding of Taxes.

(a) If the Participant makes a disposition, within the meaning of Section 424(c) of the Code and regulations promulgated thereunder, of any share or shares of Common Stock issued to such Participant pursuant to such Participant's exercise of an Option, and such disposition occurs within the two-year period commencing on the day after the Offering Date or within the one-year period commencing on the day after the Exercise Date, such Participant shall immediately, or as soon as practicable thereafter, notify the Company thereof and thereafter immediately deliver to the Company any amount of federal, state or local income taxes and other amounts which the Company informs the Participant the Company is required to withhold.

(b) Notwithstanding anything herein to the contrary, the Employer shall have the right to make such provisions as it deems necessary to satisfy any obligations to withhold federal, state, or local income taxes or other taxes incurred by reason of the issuance of Common Stock pursuant to the Plan. Notwithstanding anything herein to the contrary, the Employer may require a Participant to remit an amount equal to the required withholding amount and may invalidate any election if the Participant does not remit applicable withholding taxes. Without limiting the generality of the foregoing, any withholding obligation with regard to any Participant may be satisfied by: (i) reducing the number of shares of Common Stock otherwise deliverable to the Participant; (ii) subject to the Committee's prior consent, any method approved by the Committee; or (iii) by the Participant's payment of cash to the Company.

21.

No Employment Rights.

The establishment and operation of this Plan shall not confer any legal rights upon any Participant or other person for a continuation of employment, nor shall it interfere with the rights of an Employer to discharge any Employee and to treat him without regard to the effect which that treatment might have upon him as a Participant or potential Participant under the Plan.

22.

Severability of Provisions.

If any provision of the Plan shall be held invalid or unenforceable, such invalidity or unenforceability shall not affect any other provisions hereof, and the Plan shall be construed and enforced as if such provisions had not been included.

23.

Construction.

The use of a masculine pronoun shall include the feminine, and the singular form shall include the plural form, unless the context clearly indicates otherwise. The headings and captions herein are provided for reference and convenience only, shall not be considered part of the Plan, and shall not be employed in the construction of the Plan.

24.

Legend.

(a) The Committee may require each person receiving Common Stock pursuant to the exercise of an Option to represent to and agree with the Company in writing that the Participant is acquiring the Common Stock without a view to distribution thereof. In addition to any legend required by the Plan, the certificates for such Common Stock may include any legend that the Committee deems appropriate to reflect any restrictions on transfer.

(b) All certificates for Common Stock delivered under the Plan shall be subject to such stock transfer orders and other restrictions as the Committee may deem advisable to assist in the compliance with any applicable tax withholding laws or under the rules, regulations and other requirements of the Securities and Exchange Commission, any stock exchange upon which the Common Stock is then listed or any national securities association system upon whose system the Common Stock is then quoted, any applicable federal or state securities law and any applicable corporate law, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions.

PLEASE SUBMIT YOUR PROXY TODAY!

SEE REVERSE SIDE

FOR THREE EASY WAYS TO SUBMIT YOUR PROXY.

V TO VOTE BY MAIL PLEASE DETACH PROXY CARD HERE AND RETURN IN ENVELOPE PROVIDED V

PROXY

HENRY SCHEIN, INC.

135 Duryea Road, Melville, New York 11747

This Proxy is solicited on behalf of the Board of Directors

The undersigned, having duly received the Notice of Annual Meeting of Stockholders and the Proxy Statement, hereby appoints Stanley M. Bergman and Michael S. Ettinger as proxies (together, the "Proxies"), each with the power to act alone and with the power of substitution and revocation, to represent the undersigned and to vote, as designated below, all shares of common stock of Henry Schein, Inc. (the "Company") held of record by the undersigned on April 15, 2004, at the Annual Meeting of Stockholders to be held at 10:00 a.m. on Tuesday, May 25, 2004 at The Mark Hotel, 25 East 77th Street, New York, New York and at any adjournments or postponements thereof. The undersigned hereby revokes any previous proxies with respect to the matters covered by this Proxy. The Board of Directors recommends a vote "FOR" the following proposals.

THIS PROXY WHEN PROPERLY EXECUTED, WILL BE VOTED IN THE MANNER DIRECTED ON THIS PROXY BY THE UNDERSIGNED STOCKHOLDER. IF NO DIRECTION IS MADE, THIS PROXY WILL BE VOTED FOR THE ELECTION OF ALL NOMINEES FOR DIRECTORS LISTED IN PROPOSAL 1, FOR PROPOSAL 2,

FOR PROPOSAL 3, FOR PROPOSAL 4, AND FOR PROPOSAL 5.

PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY PROMPTLY IN THE ENCLOSED ENVELOPE.

(Continued and to be signed on the reverse side.)

SEE REVERSE SIDE

YOUR VOTE IS IMPORTANT.

Please take a moment now to submit a proxy for your shares of Henry Schein Inc. common stock for the upcoming Annual Meeting of Stockholders.

YOU CAN SUBMIT A PROXY TODAY IN ONE OF THREE WAYS:

1. **By Telephone** Please **call toll-free at 1-866-233-5382 on a touch-tone telephone** and follow the simple recorded instructions. Then, if you wish to vote as recommended by the Board of Directors, simply press 1. If you do not wish to vote as the Board recommends, you need only respond to a few simple prompts. Your proxy will be confirmed and voted as you direct. (Telephone proxies are available for residents of the U.S. and Canada only.)

OR

2. **By Internet** Please access **https://www.proxyvotenow.com/hsic**, and follow the simple instructions on the screen. Please note you must type an "s" after http.

Control Number

You may vote by Telephone or Internet anytime until 5:00 p.m. Eastern Daylight Time, on May 24, 2004.
Do not return your Proxy Card if you are voting by Telephone or Internet.

OR

3. **By Mail** If you do not have access to a touch-tone telephone or to the Internet, please complete, sign, date and return the proxy card in the envelope provided or mail to: Henry Schein Inc., c/o Innisfree M&A Incorporated, FDR Station, P.O. Box 5154, New York, NY 10150-5154.

V TO VOTE BY MAIL PLEASE DETACH PROXY CARD HERE AND RETURN IN ENVELOPE PROVIDED V

ý **Please mark votes as in this example**

THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" THE FOLLOWING PROPOSALS:

	FOR ALL nominees listed below (except as marked to the contrary)	**WITHHOLD AUTHORITY to vote for all nominees listed below**
1. PROPOSAL TO ELECT FOURTEEN DIRECTORS FOR TERMS EXPIRING IN 2005.	o	o

(01) Stanley M. Bergman, (02) Gerald A. Benjamin, (03) James P. Breslawski, (04) Mark E. Mlotek, (05) Steven Paladino, (06) Barry J. Alperin, (07) Pamela Joseph, (08) Donald J. Kabat, (09) Marvin H. Schein, (10) Irving Shafran, (11) Philip A. Laskawy, (12) Norman S. Matthews, (13) Dr. Louis W. Sullivan and (14) Dr. Margaret A. Hamburg.

TO WITHHOLD AUTHORITY TO VOTE FOR ANY INDIVIDUAL, WRITE THAT NOMINEE'S NAME IN THE SPACE PROVIDED BELOW:

____

	FOR	**AGAINST**	**ABSTAIN**
2. PROPOSAL TO AMEND AND RESTATE THE COMPANY'S 1994	o	o	o

	FOR	AGAINST	ABSTAIN
STOCK OPTION PLAN.			
3. PROPOSAL TO AMEND THE COMPANY'S 1996 NON-EMPLOYEE DIRECTOR STOCK INCENTIVE PLAN.	o	o	o
4. PROPOSAL TO ADOPT THE HENRY SCHEIN, INC. 2004 EMPLOYEE STOCK PURCHASE PLAN.	o	o	o
5. PROPOSAL TO RATIFY THE SELECTION OF BDO SEIDMAN, LLP AS THE COMPANY'S INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS FOR THE FISCAL YEAR ENDING DECEMBER 25, 2004.	o	o	o
6. IN THEIR DISCRETION, THE PROXIES ARE AUTHORIZED TO VOTE UPON SUCH OTHER BUSINESS AS MAY PROPERLY COME BEFORE THE ANNUAL MEETING OR ANY ADJOURNMENTS OR POSTPONEMENTS THEREOF.	o	o	o

Signature: ________

Signature: ________

Date: ________

Please sign above exactly as your name appears on this Proxy. Where shares are held by joint tenants, both should sign. If signing as an attorney, executor, administrator, trustee or guardian, please give your full title as such. If signing as a corporation, an authorized person should sign in full corporate name. If signing as a partnership, an authorized person should sign in full partnership name.

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