REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS

# LIBERTY BAY BANK

December 31, 2017 and 2016

MOSSADAMS

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# Report of Independent Auditors

To the Board of Directors and Shareholders
Liberty Bay Bank

## Report on the Financial Statements

We have audited the accompanying financial statements of Liberty Bay Bank, which comprise the balance sheets as of December 31, 2017 and 2016, and the related statements of operations, comprehensive (loss) income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Liberty Bay Bank as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Everett, Washington
March 15, 2018

# Liberty Bay Bank
## Balance Sheets (dollars in thousands)

**ASSETS**

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| CASH AND CASH EQUIVALENTS | | |
| Cash and due from banks | $ 2,171 | $ 1,943 |
| Overnight funds | 2,340 | 1,570 |
| Total cash and cash equivalents | 4,511 | 3,513 |
| INTEREST-BEARING DEPOSITS WITH OTHER FINANCIAL INSTITUTIONS | 119 | 12 |
| SECURITIES AVAILABLE-FOR-SALE, at fair value | 19,221 | 23,828 |
| SECURITIES HELD-TO-MATURITY, at amortized cost | 4,053 | 4,129 |
| FEDERAL HOME LOAN BANK stock | 716 | 854 |
| LOANS AND LEASES | 72,311 | 61,562 |
| Less allowance for credit losses | 739 | 735 |
| Total loans and leases, net | 71,572 | 60,827 |
| PREMISES AND EQUIPMENT, net | 1,719 | 1,622 |
| ACCRUED INTEREST RECEIVABLE | 281 | 231 |
| OTHER ASSETS | 1,118 | 1,824 |
| Total assets | $ 103,310 | $ 96,840 |

**LIABILITIES AND SHAREHOLDERS' EQUITY**

| | 2017 | 2016 |
|---|---|---|
| DEPOSITS | | |
| Noninterest-bearing | $ 21,540 | $ 19,541 |
| Interest-bearing | 57,203 | 48,664 |
| Total deposits | 78,743 | 68,205 |
| FEDERAL HOME LOAN BANK ADVANCES | 15,000 | 19,000 |
| ACCRUED INTEREST PAYABLE | 21 | 6 |
| OTHER LIABILITIES | 257 | 206 |
| Total liabilities | 94,021 | 87,417 |
| SHAREHOLDERS' EQUITY | | |
| Common stock, $1 par value, 10,000,000 shares authorized, 1,428,011 and 1,411,261 shares issued and outstanding at December 31, 2017 and 2016, respectively | 1,428 | 1,411 |
| Additional paid-in capital | 11,790 | 11,655 |
| Accumulated deficit | (3,474) | (3,255) |
| Accumulated other comprehensive loss | (455) | (388) |
| Total shareholders' equity | 9,289 | 9,423 |
| Total liabilities and shareholders' equity | $ 103,310 | $ 96,840 |

## Liberty Bay Bank
### Statements of Operations (dollars in thousands)

| | Years Ended December 31, 2017 | Years Ended December 31, 2016 |
|---|---|---|
| INTEREST AND FEE INCOME | | |
| Loans, including fees | $ 3,689 | $ 3,398 |
| Investments | 455 | 299 |
| Interest-bearing deposits with other financial institutions and overnight funds | 24 | 34 |
| Total interest and fee income | 4,168 | 3,731 |
| INTEREST EXPENSE | | |
| Deposits | 423 | 329 |
| Federal Home Loan Bank advances | 176 | 159 |
| Total interest expense | 599 | 488 |
| NET INTEREST INCOME | 3,569 | 3,243 |
| PROVISION FOR CREDIT LOSSES | 12 | 30 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 3,557 | 3,213 |
| NONINTEREST INCOME | | |
| (Loss) gain on sale of investment securities | (3) | 155 |
| Service charges on deposits | 43 | 38 |
| Other income | 72 | 74 |
| Total noninterest income | 112 | 267 |
| NONINTEREST EXPENSE | | |
| Salaries and employee benefits | 1,894 | 1,824 |
| Occupancy and equipment | 469 | 373 |
| Data processing | 262 | 257 |
| Advertising and business development | 65 | 60 |
| Professional and regulatory expenses | 239 | 247 |
| Other expenses | 316 | 321 |
| Total noninterest expense | 3,245 | 3,082 |
| NET INCOME BEFORE INCOME TAX (EXPENSE) BENEFIT | 424 | 398 |
| INCOME TAX (EXPENSE) BENEFIT | (718) | 830 |
| NET (LOSS) INCOME | $ (294) | $ 1,228 |



See accompanying notes.

# Liberty Bay Bank
## Statements of Comprehensive (Loss) Income (dollars in thousands)

| | Years Ended December 31, 2017 | Years Ended December 31, 2016 |
|---|---|---|
| NET (LOSS) INCOME | $ (294) | $ 1,228 |
| Other comprehensive income (loss) | | |
| Unrealized gain (loss) on securities available-for-sale | | |
| Unrealized holding gain (loss) | 9 | (436) |
| Tax (expense) benefit on unrealized holding gain (loss) | (3) | 159 |
| Reclassification adjustments for realized losses (gains) on sales | 3 | (155) |
| Tax (benefit) expense for realized gains (losses) on sales | (1) | 40 |
| Other comprehensive income (loss) | 8 | (392) |
| COMPREHENSIVE (LOSS) INCOME | $ (286) | $ 836 |

See accompanying notes.

# Liberty Bay Bank
## Statements of Changes in Shareholders' Equity (dollars in thousands)

| | Common Stock | | Additional Paid-in | Accumulated | Accumulated Other Comprehensive | Total Shareholders' |
|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Deficit | (Loss) Income | Equity |
| BALANCE, December 31, 2015 | 1,411,261 | $ 1,411 | $ 11,626 | $ (4,483) | $ 4 | $ 8,558 |
| Net income | - | - | - | 1,228 | - | 1,228 |
| Other comprehensive loss, net | - | - | - | - | (392) | (392) |
| Stock-based compensation | - | - | 29 | - | - | 29 |
| BALANCE, December 31, 2016 | 1,411,261 | 1,411 | 11,655 | (3,255) | (388) | 9,423 |
| Net loss | - | - | - | (294) | - | (294) |
| Proceeds from stock issuance | 16,750 | 17 | 101 | - | - | 118 |
| Other comprehensive income, net | | | | | 8 | 8 |
| Stock-based compensation | - | - | 34 | - | - | 34 |
| Reclassification from tax reform | - | - | - | 75 | (75) | - |
| BALANCE, December 31, 2017 | 1,428,011 | $ 1,428 | $ 11,790 | $ (3,474) | $ (455) | $ 9,289 |


See accompanying notes.

# Liberty Bay Bank
## Statements of Cash Flows (dollars in thousands)

| | Years Ended December 31, 2017 | 2016 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net (loss) income | $ (294) | $ 1,228 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Provision for credit losses | 12 | 30 |
| Depreciation and amortization | 154 | 103 |
| Deferred expense for income taxes | 718 | 151 |
| Net amortization of investment security premium/discount | 121 | 118 |
| Stock-based compensation | 34 | 29 |
| Loss (gain) on sale of investment securities | 3 | (155) |
| Changes in operating assets and liabilities | | |
| Accrued interest receivable | (50) | (36) |
| Other assets | (12) | (1,019) |
| Accrued interest payable | 15 | (2) |
| Other liabilities | 51 | 7 |
| Net cash provided by operating activities | 752 | 454 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net change in interest-bearing deposits with other financial institutions | (107) | 2,941 |
| Activity in securities available-for-sale | | |
| Maturities, prepayments, and calls | 3,643 | 2,507 |
| Purchases | - | (32,117) |
| Sales | 861 | 12,352 |
| Activity in securities held-to-maturity | | |
| Maturities, prepayments, and calls | 563 | 774 |
| Purchases | (500) | (1,101) |
| Redemption (purchase) of Federal Home Loan Bank stock | 138 | (363) |
| Loan and lease originations, net | (10,757) | (5,546) |
| Purchase of premises and equipment, net | (251) | (32) |
| Net cash used in investing activities | (6,410) | (20,585) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in deposits | 10,538 | 8,417 |
| Advances from the Federal Home Loan Bank | - | 9,000 |
| Repayments of advances from the Federal Home Loan Bank | (4,000) | - |
| Proceeds from stock offering | 118 | - |
| Net cash received from financing activities | 6,656 | 17,417 |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 998 | (2,714) |
| CASH AND CASH EQUIVALENTS, beginning of year | 3,513 | 6,227 |
| CASH AND CASH EQUIVALENTS, end of year | $ 4,511 | $ 3,513 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid during the year for interest | $ 584 | $ 490 |
| Transfer of other real estate owned to premises and equipment | $ - | $ 1,248 |
| NONCASH INVESTING AND FINANCING ACTIVITIES | | |
| Unrealized gain (loss) on securities available-for-sale | $ 12 | $ (591) |

See accompanying notes.

## Note 1 – Organization and Summary of Significant Accounting Policies

**Nature of operations** – Liberty Bay Bank (the Bank) provides a full range of banking services to individual and corporate customers through its main office in Poulsbo, Washington and loan production office in Port Orchard, Washington, which opened in February 2017. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial real estate loans, residential real estate loans, and commercial loans. The Bank is subject to significant competition from other financial institutions. The Bank is also subject to the regulations of certain federal and state of Washington agencies and undergoes periodic examinations by those regulatory authorities.

**Financial statement presentation and use of estimates –** The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and reporting practices applicable to the banking industry. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, as of the date of the balance sheet, and revenues and expenses for the year. Actual results could differ from estimated amounts. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for credit losses, fair value of financial instruments, and deferred tax assets. All dollar amounts are stated in thousands.

**Subsequent events** – Subsequent events are events or transactions that occur after the date of the balance sheet but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 15, 2018, the date the financial statements were issued, noting no events requiring accrual.

On February 15, 2018, the Bank entered into an agreement with Banner Bank to acquire its deposits at the Poulsbo location. The Bank will acquire the deposits of approximately $25 million and no loans, and included in the acquired accounts are both personal and business deposits. The deposits will be purchased at an estimated aggregate premium of 1.60%, with the ultimate premium subject to deposit mix upon closing. The transaction is subject to regulatory approvals and customary closing conditions and is expected to close in the second quarter of 2018.

**Cash and cash equivalents –** For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, overnight funds, and federal funds sold, all with maturities of three months or less. Generally, federal funds are purchased and sold for one-day periods. The amounts on deposit fluctuate and, at times, exceed the insured limit by the Federal Deposit Insurance Corporation (FDIC), which potentially subjects the Bank to credit risk. Overnight funds include federal funds sold and are made with major banks as approved by the board of directors.

**Interest-bearing deposits with other financial institutions** – Interest-bearing deposits with other financial institutions include interest-bearing deposits and certificates of deposit in federally insured financial institutions located throughout the United States. The amounts on deposit fluctuate and, at times, exceed the insured limit by the FDIC, which potentially subjects the Bank to credit risk.

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

**Restricted assets** – Federal Reserve Board regulations generally require maintenance of certain minimum reserve balances on deposit with the Federal Reserve Bank or another institution in a pass-through relationship. The amounts of such balances are generally based on size and other factors. There were no such requirements at December 31, 2017 or 2016.

**Investment securities –** Investment securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investment securities are classified as available-for-sale when they might be sold before maturity. Equity securities with readily determinable fair values are classified as available-for-sale. Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Investment securities are reviewed on an ongoing basis for the presence of other-than-temporary impairment (OTTI) or permanent impairment, taking into consideration current market conditions; fair value in relationship to cost; extent and nature of the change in fair value; issuer rating changes and trends; whether management intends to sell a security or if it is likely that the Bank will be required to sell the security before recovery of the amortized cost basis of the investment, which may be maturity; and other factors. For debt securities, if management intends to sell the security or it is likely that the Bank will be required to sell the security before recovering its cost basis, the entire impairment loss would be recognized in earnings as an OTTI. If management does not intend to sell the security and it is not likely that the Bank will be required to sell the security, but management does not expect to recover the entire amortized cost basis of the security, only the portion of the impairment loss representing credit losses would be recognized in earnings. The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI. The remaining impairment related to all other factors, i.e., the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive income (loss). Impairment losses related to all other factors are presented as separate categories within other comprehensive income (loss).

**Federal Home Loan Bank stock** – The Bank is a member of the Federal Home Loan Bank (FHLB) of Des Moines. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock, based on specified percentages of its outstanding FHLB advances. The Bank's investment in FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value ($100 per share).

The Bank evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on the Bank's assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The Bank has determined that there is not an other-than-temporary impairment on the FHLB stock investment as of December 31, 2017 or 2016.

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

**Loans held-for-sale** – Loans originated and intended for sale in secondary markets are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. There were no loans held-for-sale at December 31, 2017 or 2016.

**Loans** – Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in process of collection. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably ensured.

**Leases** – The Bank uses the direct finance method of accounting to record direct financing leases and related interest income. At the inception of a lease, the Bank records as an asset the minimum future lease payments receivable, plus the estimated residual value of the leased equipment, less unearned lease income. Initial direct costs and fees related to lease originations are deferred as part of the investment and amortized over the lease term. Unearned lease income is the amount by which the total lease receivable plus the estimated residual value exceeds the investment in the lease. Unearned lease income, net of initial direct costs and fees, is recognized as revenue over the lease term using the interest method.

**Significant group concentrations of credit risk** – Most of the Bank’s business activity is with customers located within Kitsap County, Washington. The Bank originates commercial, real estate, construction, and consumer loans. Generally, loans are secured by accounts receivable, inventory, deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. Although the Bank has a diversified loan portfolio, local economic conditions may affect borrowers’ ability to meet the stated repayment terms.

The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial credit was granted primarily to commercial borrowers. The Bank, as a matter of policy, does not extend credit in excess of 20% of unimpaired capital and surplus to any single borrower or group of related borrowers.

**Allowance for credit losses** – The allowance for credit losses is established as losses are estimated to have occurred through a provision for credit losses charged to earnings. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

The allowance for loan and lease losses is maintained at a level sufficient to provide for probable loan losses based on evaluating known and inherent risks in the loan and lease portfolio. The allowance is provided based upon management's continuing analysis of the pertinent factors underlying the quality of the loan and lease portfolio. These factors include changes in the size and composition of the loan and lease portfolio, delinquency levels, actual loan and lease loss experience, current economic conditions, and detailed analysis of individual loans and leases for which full collectibility may not be ensured. The detailed analysis includes techniques to estimate the fair value of loan and lease collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general, and unallocated components. The specific component relates to loans and leases that are classified as impaired.

For such loans or leases classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan or lease is lower than the carrying value of that loan or lease. The general component covers nonimpaired loans and leases and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The appropriateness of the allowance for credit losses is estimated based upon these factors and trends identified by management at the time the financial statement is prepared.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan or lease agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans and leases that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured by either the present value of expected future cash flows discounted at the credit's effective interest rate, the credit's obtainable market price, or the fair value of the collateral if the credit is collateral-dependent. Impairment is measured on a loan-by-loan basis for all loans in the portfolio except for the smaller groups of homogeneous consumer loans in the portfolio. Additionally, state and federal regulations, upon examination, may require the Bank to make additional provisions or adjustments to its allowance.

**Transfers of financial assets** – Transfers of an entire financial asset, a group of entire financial assets, or participating interest in an entire financial asset are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) 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 (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Note 1 – Organization and Summary of Significant Accounting Policies (continued)**

**Premises and equipment** – Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets. Gains or losses on dispositions are reflected in earnings. Assets are reviewed for impairment when events indicate that their carrying value may not be recoverable. If management determines impairment exists, the assets are reduced with an offsetting charge to expense.

**Foreclosed assets** – Foreclosed assets include real estate and personal property acquired through foreclosure and in-substance foreclosed properties. In-substance foreclosed properties are those properties for which the institution has taken physical possession, regardless of whether formal foreclosure proceedings have taken place.

At the time of foreclosure, foreclosed property is recorded at the fair value less cost to sell, which becomes the property's new basis. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for credit losses. After foreclosure, valuations are periodically performed by management and foreclosed property is carried at the lower of the new cost basis or fair value less costs to sell. Costs incurred in maintaining foreclosed property and subsequent adjustments to the carrying amount of the property are included in noninterest expense.

**Income taxes –** Income taxes are accounted for using an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement and tax basis of assets and liabilities at the applicable enacted tax rates. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Bank evaluates the realizability of its deferred tax assets by assessing its valuation allowance and by adjusting the amount of such allowance, if necessary.

**Financial instruments –** In the ordinary course of business, the Bank enters into off-balance-sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, standby letters of credit, and financial guarantees. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

**Advertising costs –** The Bank expenses advertising costs as they are incurred. Total advertising expenses were $14 and $11 in 2017 and 2016, respectively.

**Comprehensive income** – Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale investments, are reported as a separate component of the equity section of the balance sheets. Reclassification adjustments during December 31, 2017 and 2016, are included within the statements of comprehensive (loss) income.

**Notes to Financial Statements (dollars in thousands)**

### Note 1 – Organization and Summary of Significant Accounting Policies (continued)

**Stock-based compensation** – The Bank has a stock-based compensation plan for employees that includes stock options and restricted stock, which are recognized as stock-based compensation expense in the statements of income based on the grant-date fair value of the award with a corresponding increase in common stock. The fair value is amortized over the requisite service period, which is generally the vesting period. The fair value at the grant date is determined using the Black-Scholes pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock, the expected dividend yield, and the risk-free interest rate over the expected life of the option. The Black-Scholes option valuation model requires the input of subjective assumptions, including the expected life of the share-based award and stock price volatility. The assumptions used represent management’s best estimates, but these estimates involve inherent uncertainties and the application of management’s judgment.

**Fair value measurements** – Fair value measurements are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risks, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

### Note 2 – Investments

The amortized cost of securities and their approximate fair value are as follows:

| **December 31, 2017** | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Securities available-for-sale | | | | |
| Mortgage-backed securities | $ 19,797 | $ - | $ (576) | $ 19,221 |
| Held-to-maturity | | | | |
| Mortgage-backed securities | $ 3,561 | $ - | $ (62) | $ 3,499 |
| SBA security | 492 | - | - | 492 |
| | $ 4,053 | $ - | $ (62) | $ 3,991 |
| **December 31, 2016** | | | | |
| Securities available-for-sale | | | | |
| Mortgage-backed securities | $ 24,415 | $ 10 | $ (597) | $ 23,828 |
| Held-to-maturity | | | | |
| Mortgage-backed securities | $ 4,129 | $ - | $ (123) | $ 4,006 |

**Notes to Financial Statements (dollars in thousands)**

### Note 2 – Investments (continued)

The amortized cost and estimated fair value of investment securities at December 31, 2017, by contractual or expected maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Available-for-Sale | | Held-to-Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Estimated Fair Value | Amortized Cost | Estimated Fair Value |
| Due in 5 to 10 years | $ 4,384 | $ 4,306 | $ - | $ - |
| Due after 10 years | 15,413 | 14,915 | 3,561 | 3,499 |
| | $ 19,797 | $ 19,221 | $ 3,561 | $ 3,499 |

As of December 31, 2017, securities with a carrying value of $12,297 were pledged to secure borrowings at the FHLB and securities with a carrying value of $5,871 were pledged to secure public deposits. As of December 31, 2016, securities with a carrying value of $10,762 were pledged to secure borrowings at the FHLB and securities with a carrying value of $1,366 were pledged to secure public deposits.

During the year ended December 31, 2017, the Bank sold $861 in investment securities, realizing gross losses of $2. During the year ended December 31, 2016, the Bank sold $12,352 in investment securities, realizing gross gains of $155 and no losses.

At December 31, 2017 and 2016, 41 securities were in an unrealized loss position. Of the 41 securities in a loss position at year-end 2017, 39 had been in a loss position for more than 12 months. The Bank has evaluated these securities and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any bank- or industry-specific event. The Bank anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment. Because management does not intend to sell and does not anticipate to be required to sell these securities in the near term, no declines are deemed to be other than temporary.

**Notes to Financial Statements (dollars in thousands)**

**Note 2 – Investments (continued)**

Information pertaining to investment securities with gross unrealized losses aggregated by investment category and length of time that individual securities have been in a continuous loss position is as follows at December 31:

| | Less Than 12 Months | | Over 12 Months | | |
|---|---|---|---|---|---|
| **December 31, 2017** | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Total Unrealized Losses |
| Securities available-for-sale | | | | | |
| Mortgage-backed securities | $ 12 | $ 1,163 | $ 564 | $ 18,058 | $ 576 |
| Held-to-maturity | | | | | |
| Mortgage-backed securities | $ - | $ - | $ 62 | $ 3,149 | $ 62 |
| **December 31, 2016** | | | | | |
| Securities available-for-sale | | | | | |
| Mortgage-backed securities | $ 597 | $ 22,368 | $ - | $ - | $ 597 |
| Held-to-maturity | | | | | |
| Mortgage-backed securities | $ 123 | $ 4,006 | $ - | $ - | $ 123 |

**Note 3 – Loans, Leases, and Allowance for Credit Losses**

The major classifications of loans and leases at December 31 are as follows:

| | 2017 | 2016 |
|---|---|---|
| Commercial real estate | $ 34,485 | $ 34,275 |
| Commercial | 13,100 | 6,387 |
| Construction and land | 7,809 | 7,709 |
| Consumer | 377 | 675 |
| Residential real estate | 16,540 | 12,578 |
| Leases | - | 18 |
| Gross loans and leases | 72,311 | 61,642 |
| Premium on purchased loans, net | 255 | 125 |
| Deferred fees and costs, net | (255) | (205) |
| Allowance for credit losses | (739) | (735) |
| Total loans and leases, net | $ 71,572 | $ 60,827 |

**Notes to Financial Statements (dollars in thousands)**

**Note 3 – Loans, Leases, and Allowance for Credit Losses (continued)**

Net investment in leases is summarized as follows at December 31:

| | 2016 |
|---|---|
| Minimum lease payments receivable | $ 18 |
| Unearned income | - |
| | $ 18 |

The Bank did not have any investments in leases as of December 31, 2017. The Bank pledged certain commercial loans as collateral for purposes of borrowings with the FHLB. Loans totaling $16,392 were pledged to the FHLB at December 31, 2017 (Note 6).

The following table presents the activity in the allowance for credit losses by segment for the years ended December 31:

| **2017** | Beginning Balance | Provision (Recovery) for Credit Losses | Charge-offs | Recoveries | Ending Balance |
|---|---|---|---|---|---|
| Commercial real estate | $ 278 | $ (9) | $ - | $ - | $ 269 |
| Commercial | 64 | 63 | (9) | 1 | 119 |
| Construction and land | 110 | (29) | - | - | 81 |
| Consumer | 6 | (4) | - | - | 2 |
| Residential real estate | 52 | 73 | - | - | 125 |
| Unallocated | 225 | (82) | - | - | 143 |
| | $ 735 | $ 12 | $ (9) | $ 1 | $ 739 |
| **2016** | | | | | |
| Commercial real estate | $ 306 | $ (28) | $ - | $ - | $ 278 |
| Commercial | 55 | 19 | (10) | - | 64 |
| Construction and land | 178 | (68) | - | - | 110 |
| Consumer | 7 | (1) | - | - | 6 |
| Residential real estate | 24 | 28 | - | - | 52 |
| Leases | 2 | (2) | - | - | - |
| Unallocated | 143 | 82 | - | - | 225 |
| | $ 715 | $ 30 | $ (10) | $ - | $ 735 |

Impairment is measured on a loan-by-loan basis for all loans in the portfolio except for the smaller groups of homogeneous consumer loans in the portfolio.

**Notes to Financial Statements (dollars in thousands)**

**Note 3 – Loans, Leases, and Allowance for Credit Losses (continued)**

The following table presents loans individually evaluated for impairment by class of loans as of December 31:

| 2017 | Recorded Investments (Loan Balance Less Charge-off) | Unpaid Principal Balance | Related Allowance | Average Investment in Impaired Loans | Interest Income Recognized |
|---|---|---|---|---|---|
| With no allowance recorded | | | | | |
| Commercial | $ 8 | $ 8 | $ - | $ 9 | $ 1 |
| **2016** | | | | | |
| With no allowance recorded | | | | | |
| Commercial | $ 10 | $ 10 | $ - | $ 5 | $ - |

The following table presents the balance in the allowance for credit losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31:

| | Allowance for Credit Losses | | | Loans and Leases | | |
|---|---|---|---|---|---|---|
| **2017** | Ending Balance | Ending Balance Individually Evaluated for Impairment | Ending Balance Collectively Evaluated for Impairment | Ending Balance | Ending Balance Individually Evaluated for Impairment | Ending Balance Collectively Evaluated for Impairment |
| Commercial real estate | $ 269 | $ - | $ 269 | $ 34,485 | $ - | $ 34,485 |
| Commercial | 119 | - | 119 | 13,100 | 8 | 13,092 |
| Construction and land | 81 | - | 81 | 7,809 | - | 7,809 |
| Consumer | 2 | - | 2 | 377 | - | 377 |
| Residential real estate | 125 | - | 125 | 16,540 | - | 16,540 |
| Unallocated | 143 | - | 143 | - | - | - |
| | $ 739 | $ - | $ 739 | $ 72,311 | $ 8 | $ 72,303 |
| **2016** | | | | | | |
| Commercial real estate | $ 278 | $ - | $ 278 | $ 34,275 | $ - | $ 34,275 |
| Commercial | 64 | - | 64 | 6,387 | 10 | 6,377 |
| Construction and land | 110 | - | 110 | 7,709 | - | 7,709 |
| Consumer | 6 | - | 6 | 675 | - | 675 |
| Residential real estate | 52 | - | 52 | 12,578 | - | 12,578 |
| Leases | - | - | - | 18 | - | 18 |
| Unallocated | 225 | - | 225 | - | - | - |
| | $ 735 | $ - | $ 735 | $ 61,642 | $ 10 | $ 61,632 |

**Past due loans** – Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due.

**Notes to Financial Statements (dollars in thousands)**

### Note 3 – Loans, Leases, and Allowance for Credit Losses (continued)

The following table presents current and past due loans, net of partial loan charge-offs, by type and delinquency status, as of December 31:

| 2017 | 30 - 59 Days Past Due | 60 - 89 Days Past Due | 90 Days or More Past Due | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| Commercial real estate | $ - | $ - | $ - | $ - | $ 34,485 | $ 34,485 |
| Commercial | - | - | 8 | 8 | 13,092 | 13,100 |
| Construction and land | - | - | - | - | 7,809 | 7,809 |
| Consumer | - | - | - | - | 377 | 377 |
| Residential real estate | - | - | - | - | 16,540 | 16,540 |
| | $ - | $ - | $ 8 | $ 8 | $ 72,303 | $ 72,311 |
| **2016** | | | | | | |
| Commercial real estate | $ - | $ - | $ - | $ - | $ 34,275 | $ 34,275 |
| Commercial | - | - | 10 | 10 | 6,377 | 6,387 |
| Construction and land | - | - | - | - | 7,709 | 7,709 |
| Consumer | - | - | - | - | 675 | 675 |
| Residential real estate | - | - | - | - | 12,578 | 12,578 |
| Leases | - | - | - | - | 18 | 18 |
| | $ - | $ - | $ 10 | $ 10 | $ 61,632 | $ 61,642 |

**Credit quality indicator** – Federal regulations provide for the classification of lower quality loans and other assets, such as debt and equity securities, as substandard, doubtful, or loss. An asset is considered substandard if it is inadequately protected by the current net worth and pay capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable on the basis of currently existing facts, conditions, and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When the Bank classifies problem assets as either substandard or doubtful, it may establish a specific allowance to address the risk specifically or the Bank may allow the loss to be addressed in the general allowance. General allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities, but, unlike specific allowances, have not been specifically allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose the Bank to sufficient risk to warrant classification as substandard or doubtful but possess identified weaknesses are designated as either watch or special mention assets. At December 31, 2017, the Bank had no loans classified as loss.

Additionally, the Bank categorizes loans as performing or nonperforming based on payment activity. Loans that are more than 90 days past due and nonaccrual loans are considered nonperforming.

**Notes to Financial Statements (dollars in thousands)**

### Note 3 – Loans, Leases, and Allowance for Credit Losses (continued)

The following tables represent the credit risk profile by internally assigned grade and performing status as of December 31, 2017 and 2016, by class of loans:

**Credit Risk Profile by Internally Assigned Grade**

| **2017** | Commercial Real Estate | Commercial | Construction and Land | Consumer | Residential Real Estate | Leases | Total |
|---|---|---|---|---|---|---|---|
| Grade | | | | | | | |
| Pass | $ 33,879 | $ 12,192 | $ 7,208 | $ 377 | $ 16,540 | $ - | $ 70,196 |
| Watch | - | 804 | 601 | - | - | - | 1,405 |
| Special mention | - | - | - | - | - | - | - |
| Substandard | 606 | 96 | - | - | - | - | 702 |
| Doubtful | - | 8 | - | - | - | - | 8 |
| | $ 34,485 | $ 13,100 | $ 7,809 | $ 377 | $ 16,540 | $ - | $ 72,311 |

| **2016** | Commercial Real Estate | Commercial | Construction and Land | Consumer | Residential Real Estate | Leases | Total |
|---|---|---|---|---|---|---|---|
| Grade | | | | | | | |
| Pass | $ 32,471 | $ 5,384 | $ 6,422 | $ 675 | $ 12,578 | $ 14 | $ 57,544 |
| Watch | 619 | 993 | 39 | - | - | 4 | 1,655 |
| Special mention | 1,185 | - | 1,248 | - | - | - | 2,433 |
| Substandard | - | - | - | - | - | - | - |
| Doubtful | - | 10 | - | - | - | - | 10 |
| | $ 34,275 | $ 6,387 | $ 7,709 | $ 675 | $ 12,578 | $ 18 | $ 61,642 |

There were three nonaccrual commercial loans with a balance of $8 at December 31, 2017, and two at December 31, 2016 with a balance of $10. There were no loans 90 days or more past due and still accruing at December 31, 2017 or 2016.

A troubled debt restructuring is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Bank is granting the borrower a concession of some kind.

Upon identifying those receivables as troubled debt restructurings, the Bank will identify them as impaired for purposes of determining the allowance for loan losses. This requires the loans to be evaluated individually for impairment, generally based on the expected cash flows under the new terms discounted at the loans' original effective interest rates. For troubled debt restructured loans that subsequently default, the method of determining impairment is generally the fair value of the collateral less estimated selling costs. There were no loans modified by the Bank as troubled debt restructurings at December 31, 2017 and 2016, or modified during the years then ended.

**Notes to Financial Statements (dollars in thousands)**

**Note 4 – Premises and Equipment**

Bank land, leaseholds and equipment at December 31 are classified as follows:

| | 2017 | 2016 |
|---|---|---|
| Land | $ 132 | $ 132 |
| Building | 1,275 | 1,115 |
| Leasehold improvements | 720 | 720 |
| Furniture, fixtures, and office equipment | 486 | 412 |
| Vehicles | 23 | 23 |
| | 2,636 | 2,402 |
| Less accumulated depreciation and amortization | (917) | (780) |
| | $ 1,719 | $ 1,622 |

The Bank leased its main office in Poulsbo, Washington at standard market rates. The Bank renewed its original lease for its main office location in 2018 for an additional three-year term ending in 2021. There are no more renewal options remaining in the original lease contract. The lease requires the Bank to pay its pro rata share of building operating expenses. The annual lease through the initial lease term and renewal options is as follows:

| | |
|---|---|
| 2018 | $ 260 |
| 2019 | 265 |
| 2020 | 270 |
| 2021 | 114 |
| | $ 909 |

Rental expense, including operating expenses charged to operations, was $258 and $249 for the years ended December 31, 2017 and 2016, respectively.

During 2016, the Bank converted a bank-owned property in Port Orchard, Washington into office space for the purposes of opening a loan production office. The loan production office opened in February 2017. In August 2017, the Bank leased a portion of the building to an unaffiliated third party. The lease includes an option to purchase the building which expires in June 2020. During the option term, a portion of lease payments per year will be applied to the purchase price upon exercising the option. The Bank is deferring these receipts so long as the purchase option exists.

Minimum rental receipts under the lease agreement for future years ending December 31 are as follows:

| | |
|---|---|
| 2018 | $ 70 |
| 2019 | 75 |
| 2020 | 75 |
| 2021 | 75 |
| 2022 | 44 |
| | $ 339 |

Notes to Financial Statements (dollars in thousands)

## Note 5 – Deposits

Deposits as of December 31 consisted of the following:

| | 2017 | 2016 |
|---|---|---|
| Savings accounts | $ 8,471 | $ 6,930 |
| Certificates of deposit | 13,894 | 7,082 |
| Demand accounts | | |
| Noninterest-bearing | 21,540 | 19,541 |
| Interest-bearing | 8,829 | 7,949 |
| Money market accounts | 26,009 | 26,703 |
| | $ 78,743 | $ 68,205 |

At December 31, scheduled maturities of certificates of deposit are as follows:

| | |
|---|---|
| 2018 | $ 10,950 |
| 2019 | 2,827 |
| 2020 | 117 |
| | $ 13,894 |

The Bank had $8,077 and $3,552 of certificates of deposit that met or exceeded the $250,000 federally insured limit at December 31, 2017 and 2016, respectively.

## Note 6 – Credit Arrangements

At December 31, 2017, committed line-of-credit agreements totaling approximately $8.0 million were available to the Bank from unaffiliated banks, subject to interest at then-current rates. Such lines generally provide for interest at the lending bank's prime rate or other money market rates. These arrangements require total compensating balances of at least $485 maintained in a demand deposit account. The compensating balances are included in cash and cash equivalents at December 31, 2017.

The Bank is a member of the FHLB of Des Moines, and as such, is eligible for a credit line up to 35% of total assets, subject to certain collateral requirements. At December 31, 2017, loans and investments pledged as collateral to the FHLB equated to a borrowing capacity of $36,159, when fully collateralized. Borrowings generally provide for interest at the then-current published rates and are subject to certain reserve rates. Borrowings must be secured by eligible investments held at the FHLB.

At December 31, 2017, the Bank had $15,000 of total advances outstanding with the FHLB, of which $6,000 were short-term revolving advances and $9,000 were long-term advances with a weighted-average rate of 1.47%. Current borrowings are collateralized by pledged investment securities (Note 2) and loans (Note 3). The excess balance of all collateral can be used for additional borrowings. At December 31, 2017, the Bank had committed $2,000 of forward starting advances with the FHLB at predetermined fixed rates to be advanced in 2018 and 2019.

**Notes to Financial Statements (dollars in thousands)**

### Note 6 – Credit Arrangements (continued)

The contractual maturities of long-term FHLB advances at December 31, 2017, are as follows:

| | | |
|---|---|---|
| 2018 | $ | 2,000 |
| 2019 | | 3,500 |
| 2020 | | 2,500 |
| 2021 | | 1,000 |
| | $ | 9,000 |

### Note 7 – Income Taxes

Income taxes consist of the following for the years ended December 31:

| | 2017 | 2016 |
|---|---|---|
| Deferred | $ 718 | $ 151 |
| Change in valuation allowance | - | (981) |
| Total tax expense (benefit) | $ 718 | $ (830) |

The following is a reconciliation between the statutory and the effective federal income tax rate for the years ended December 31:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Amount | Percent of Pre-Tax Income | Amount | Percent of Pre-Tax Income |
| Income tax at statutory rates | $ 144 | 34 | $ 135 | 34 |
| Increase (decrease) resulting from | | | | |
| Permanent differences | 13 | 3 | 16 | 4 |
| Change in federal tax rate | 561 | 132 | - | - |
| Valuation allowance reversal | - | - | (981) | (247) |
| Total income tax expense (benefit) | $ 718 | 169 | $ (830) | (209) |

**Notes to Financial Statements (dollars in thousands)**

**Note 7 – Income Taxes (continued)**

The nature and components of the Bank's net deferred tax asset at December 31 are as follows:

| | 2017 | 2016 |
|---|---|---|
| Deferred tax assets | | |
| Net operating loss carryforward | $ 552 | $ 975 |
| Organization expenditures | 122 | 228 |
| Property and equipment depreciation | 36 | 58 |
| Unrealized loss on securities | 121 | 199 |
| Other, net | 16 | 20 |
| Allowance for credit losses | 144 | 228 |
| Subtotal | 991 | 1,708 |
| Deferred tax liabilities | | |
| Cash basis method of accounting | 25 | 40 |
| Deferred costs | 54 | 38 |
| Subtotal | 79 | 78 |
| Net deferred tax asset | $ 912 | $ 1,630 |

The Bank's 2017 results included the impact of the enactment of the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017. The law includes significant changes to the U.S. corporate tax system, including a Federal corporate rate change reduction from 34% to 21%. In 2017, the Bank applied this newly enacted corporate federal income tax rate of 21%, resulting in approximately a $561 increase in tax expense. The final impact of the tax rate change may differ due to changes in assumptions made by the Bank or actions the Bank may take as a result of tax reform.

A valuation allowance is required for deferred tax assets if, based on available evidence, it is more-likely-than-not that all or some portion of the asset will not be realized due to the inability to generate sufficient taxable income to use the benefit of the deferred tax asset. After evaluating the positive and negative evidence associated with the deferred tax asset, including the consideration of the Bank's earnings history over the recent three-year period, and projections, the Bank determined that the deferred tax asset could be supported at December 31, 2017 and 2016.

At December 31, 2017, the Bank has, for tax reporting purposes, a net operating loss carryforward totaling approximately $2,625, eligible to offset future federal income taxes. The net operating loss carryforward will begin to expire in 2029.

At December 31, 2017, the Bank had unamortized preopening expenditures of approximately $581 (for tax reporting purposes) that can be used to offset future federal income taxes. These expenditures are amortizing over 15 years on the straight-line basis at a rate of approximately $91 per year.

### Note 7 – Income Taxes (continued)

The Bank recognizes the tax benefit from uncertain tax positions only if it is more likely than not that the tax positions will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefit is measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Bank had no uncertain tax positions at December 31, 2017 or 2016.

The Bank's policy is to recognize interest and penalties in tax expense. During the years ended December 31, 2017 and 2016, the Bank recognized no interest or penalties.

The Bank files income tax returns in the U.S. federal jurisdiction. In general, the Bank is no longer subject to U.S. federal income tax examinations by tax authorities for the years before 2014.

### Note 8 – Employee Benefits

The Bank has a 401(k) defined contribution plan for those employees who meet the eligibility requirements. Individuals who are 21 years of age and have completed three consecutive months of service are considered eligible to participate. Eligible employees can contribute up to an amount or percentage of compensation not to exceed certain limits based on federal tax laws. The Bank has elected discretionary matching contributions under the plan. Matching contributions vest at 20% per year after the first year and will be fully vested after six years of service. The Bank contributed $20 for the year ended December 31, 2017. No contributions were made for the year ended December 31, 2016.

### Note 9 – Stock-Based Compensation

The Bank has an equity incentive plan (the Plan), which is shareholder-approved and permits the grant of incentive stock options, nonqualified stock options, and restricted stock awards at the discretion of the compensation committee. The Plan provides for up to a maximum of 235,000 shares of authorized common stock; of this amount, no more than 100,000 shares may be granted as restricted stock to certain key employees and directors. There were 45,280 remaining shares in the Plan available to grant at December 31, 2017. The Bank believes that such awards better align the interests of its employees with those of its shareholders. Option awards are generally granted with an exercise price equal to or greater than the market price of the Bank's stock at the date of grant; those option awards generally vest and become exercisable in incremental percentages over 5 years of continuous service from the grant date and expire after 10 years.

Notes to Financial Statements (dollars in thousands)

**Note 9 – Stock-Based Compensation (continued)**

The fair value of each option award is estimated on the date of grant using the Black-Scholes valuation model that uses the assumptions noted in the following table. Because the Black-Scholes valuation model incorporates ranges of assumptions of inputs, those ranges are disclosed. Expected volatilities are based on historical volatility of the Bank's stock and other factors. The Bank uses market and peer data to estimate option exercises and employee termination within the option valuation model, segregated into separate groups of employees that have similar historical exercise behavior, which are considered separately for valuation purposes. The expected term of options represents the period of time that options granted are expected to be outstanding. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The weighted-average Black-Scholes inputs for grants issued during 2017, are as follows:

| | |
|---|---|
| Weighted-average risk-free interest rate | 2.00% |
| Dividend yield rate | 0.00% |
| Expected volatility | 16.90% |
| Expected term (in years) | 7.0 |

There were no options granted in 2016.

A summary of stock option transactions is presented below:

| | Granted Options for Common Stock | Weighted-Average Exercise Price of Shares Under Plan | Weighted-Average Remaining Contractual Term |
|---|---|---|---|
| Outstanding at December 31, 2016 | $ 126,720 | $ 5.68 | 5.7 |
| Granted | 63,000 | 7.48 | |
| Exercised | - | - | |
| Forfeited | - | - | |
| Outstanding at December 31, 2017 | 189,720 | 6.28 | 7.0 |
| Options exercisable at December 31, 2017 | 98,576 | 5.66 | 5.7 |

At December 31, 2017, there was approximately $106 of total unrecognized compensation cost related to share-based compensation arrangements. The cost is expected to be recognized over a period of approximately 5 years.

**Notes to Financial Statements (dollars in thousands)**

## Note 10 – Shareholders' Equity

**Warrants** – At December 31, 2017 and 2016, there were warrants outstanding to purchase 172,000 shares of the Bank's common stock at $10 per share, which were issued in connection with the Bank's initial offering. The warrants have a term of 10 years and expire on June 5, 2019.

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Common equity Tier 1, and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2017 and 2016, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2017, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier I risk-based, Common equity Tier 1, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31 are also presented in the table:

| | Actual | | For Capital Adequacy Purposes | | For Capital Adequacy with Capital Buffer | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2017** | | | | | | | | |
| Total capital (to risk-weighted assets) | $ 9,805 | 13.96% | $ 5,619 | 8.00% | $ 6,497 | 9.25% | $ 7,024 | 10.00% |
| Tier I capital (to risk-weighted assets) | 9,058 | 12.90% | 4,214 | 6.00% | 5,092 | 7.25% | 5,619 | 8.00% |
| Common equity Tier 1 capital (to risk-weighted assets) | 9,058 | 12.90% | 3,161 | 4.50% | 4,039 | 5.75% | 4,566 | 6.50% |
| Tier I capital (to average assets) | 9,058 | 9.21% | 3,934 | 4.00% | N/A | | 4,918 | 5.00% |
| **As of December 31, 2016** | | | | | | | | |
| Total capital (to risk-weighted assets) | $ 9,544 | 14.32% | $ 5,333 | 8.00% | $ 5,753 | 8.63% | $ 6,666 | 10.00% |
| Tier I capital (to risk-weighted assets) | 8,801 | 13.20% | 4,000 | 6.00% | 4,420 | 6.63% | 5,333 | 8.00% |
| Common equity Tier 1 capital (to risk-weighted assets) | 8,801 | 13.20% | 3,000 | 4.50% | 3,420 | 5.13% | 4,333 | 6.50% |
| Tier I capital (to average assets) | 8,801 | 9.44% | 3,730 | 4.00% | N/A | | 4,662 | 5.00% |

**Notes to Financial Statements (dollars in thousands)**

**Note 10 – Shareholders' Equity (continued)**

Banking regulations limit the transfer of assets in the form of dividends from the Bank to its shareholders. Dividends may also be subject to approval by regulators depending upon the financial condition of the Bank.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2017 is 1.25%. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2017, that the Bank meets all capital adequacy requirements to which it is subject.

**Note 11 – Related Party Transactions**

Certain directors, executive officers, and principal shareholders are Bank customers and have had banking transactions with the Bank. All loans and commitments included in such transactions were made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectibility or present any other unfavorable features. The activity of related party loans through December 31 is as follows:

| | 2017 | 2016 |
|---|---|---|
| Balance, beginning of year | $ 3,271 | $ 3,579 |
| New loans | - | - |
| Repayments | (349) | (308) |
| Balance, end of year | $ 2,922 | $ 3,271 |

There were $12,104 and $10,983 of related party deposits at December 31, 2017 and 2016, respectively.

Note 12 has been combined into Note 1 Subsequent Events

**Note 13 – Commitments and Contingencies**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit, and financial guarantees. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The contract or notional amounts of these instruments reflect the extent of the Bank's involvement in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, standby letters of credit, and financial guarantees written is represented by the contractual notional amount of these instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

**Notes to Financial Statements (dollars in thousands)**

### Note 13 – Commitments and Contingencies (continued)

**Commitments to extend credit, standby letters of credit, and financial guarantees** – Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank's experience has been that approximately 45% of loan commitments are drawn upon by customers. The Bank evaluates customers' creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, income-producing commercial properties, and other real estate.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit and financial guarantees is essentially the same as that involved in extending loan facilities to customers. The Bank maintains various levels of collateral supporting those commitments for which collateral is deemed necessary.

The Bank has not been required to perform on any financial guarantees. The Bank has not incurred any losses on its commitments in 2017 or 2016.

A summary of the notional amounts of the Bank's financial instruments with off-balance-sheet risk at December 31 follows:

| | 2017 | 2016 |
|---|---|---|
| Commitments to extend credit | | |
| Real estate secured | $ 3,925 | $ 3,412 |
| Commercial real estate, construction, and land development | 6,637 | 2,373 |
| Other | 3,116 | 4,113 |
| Total commitments to extend credit | $ 13,678 | $ 9,898 |

**Contingencies** – At periodic intervals, the state of Washington and the FDIC routinely examine the Bank's financial statements as part of their legally prescribed oversight of the banking system. Based on these examinations, the regulators can direct that the Bank's financial statements be adjusted in accordance with their findings.

Various legal claims also arise from time to time in the normal course of business that, in the opinion of management, will have no material effect on the Bank's financial statements.

**Note 14 – Fair Value Measurements**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The accounting guidance establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. In determining fair value, the Bank maximizes the use of observable inputs and minimizes the use of unobservable inputs.

Observable inputs are those assumptions that market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Bank.

Unobservable inputs are assumptions based on the Bank's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date.

There is a three-level valuation hierarchy for determining fair value that is based on the transparency of the inputs used in the valuation process. The inputs used in determining fair value in each of the three levels of the hierarchy are as follows:

**Level 1** – Quoted prices (unadjusted) in active markets for identical assets or liabilities.

**Level 2** – Either: (i) quoted prices for similar assets or liabilities; (ii) observable inputs, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data.

**Level 3** – Unobservable inputs.

The hierarchy gives the highest ranking to Level 1 inputs and the lowest ranking to Level 3 inputs. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the overall fair value measurement.

There were no transfers between levels during the years ended December 31, 2017 or 2016.

**Qualitative disclosures of valuation techniques**

**Securities available-for-sale** – Where quoted prices are available in an active market, securities are classified as Level 1. Level 1 instruments include highly liquid government bonds, securities issued by the U.S. Treasury, and exchange-traded equity securities. If quoted prices are not available, management determines fair value using pricing models, quoted prices of similar securities, or discounted cash flows. Such instruments are classified as Level 2. In certain cases, where there is limited activity in the market for particular instruments, assumptions must be made to determine their fair value. Such instruments are classified as Level 3.

**Assets and liabilities measured at fair value on a recurring basis** – Assets and liabilities are considered to be fair valued on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly, or quarterly).

**Notes to Financial Statements (dollars in thousands)**

**Note 14 – Fair Value Measurements (continued)**

The following table shows the Bank's assets and liabilities measured at fair value on a recurring basis at December 31:

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| **2017** | | | | |
| Mortgage-backed securities | $ - | $ 19,221 | $ - | $ 19,221 |
| **2016** | | | | |
| Mortgage-backed securities | $ - | $ 23,828 | $ - | $ 23,828 |

**Assets measured at fair value on a nonrecurring basis** – Assets are considered to be fair valued on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheets. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements that require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value. The following table presents the Bank's assets measured at fair value on a nonrecurring basis:

| **December 31, 2017** | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Impaired loans | $ - | $ - | $ 8 | $ 8 |
| **December 31, 2016** | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans | $ - | $ - | $ 10 | $ 10 |

Valuations of impaired loans are periodically performed by management, and the fair value of the loans is carried at the fair value of the underlying collateral less cost to foreclose, sell, and carry the collateral. Fair value of the underlying collateral is determined by an appraisal performed by a qualified independent appraiser.

**Quantitative information about Level 3 fair value measurements** – The range and weighted average of the significant unobservable inputs used to fair value Level 3 nonrecurring assets during the years ending December 31, 2017 and 2016, along with the valuation techniques used, are shown in the following table:

| | Fair Value at December 31, 2017 | Valuation Technique | Unobservable Input | Range [1] |
|---|---|---|---|---|
| Impaired loans | $ 8 | Government guarantee | Illiquid market | 0% - 10% |

[1] Discount for selling costs.

| | Fair Value at December 31, 2016 | Valuation Technique | Unobservable Input | Range [1] |
|---|---|---|---|---|
| Impaired loans | $ 10 | Government guarantee | Illiquid market | 0% - 10% |

[1] Discount for selling costs.

**Note 14 – Fair Value Measurements (continued)**

Fair value estimates are subjective in nature and involve uncertainties and matters of significant judgment; therefore, they are not necessarily indicative of the amounts the Bank could realize in a current market exchange. The Bank has not included certain material items in its disclosure, such as the value of the long-term relationships with the Bank's lending and deposit clients, because this is an intangible and not a financial instrument. Additionally, the estimates do not include any tax ramifications. There may be inherent weaknesses in any calculation technique and changes in the underlying assumptions used, including discount rates and estimates of future cash flows that could materially affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Bank.