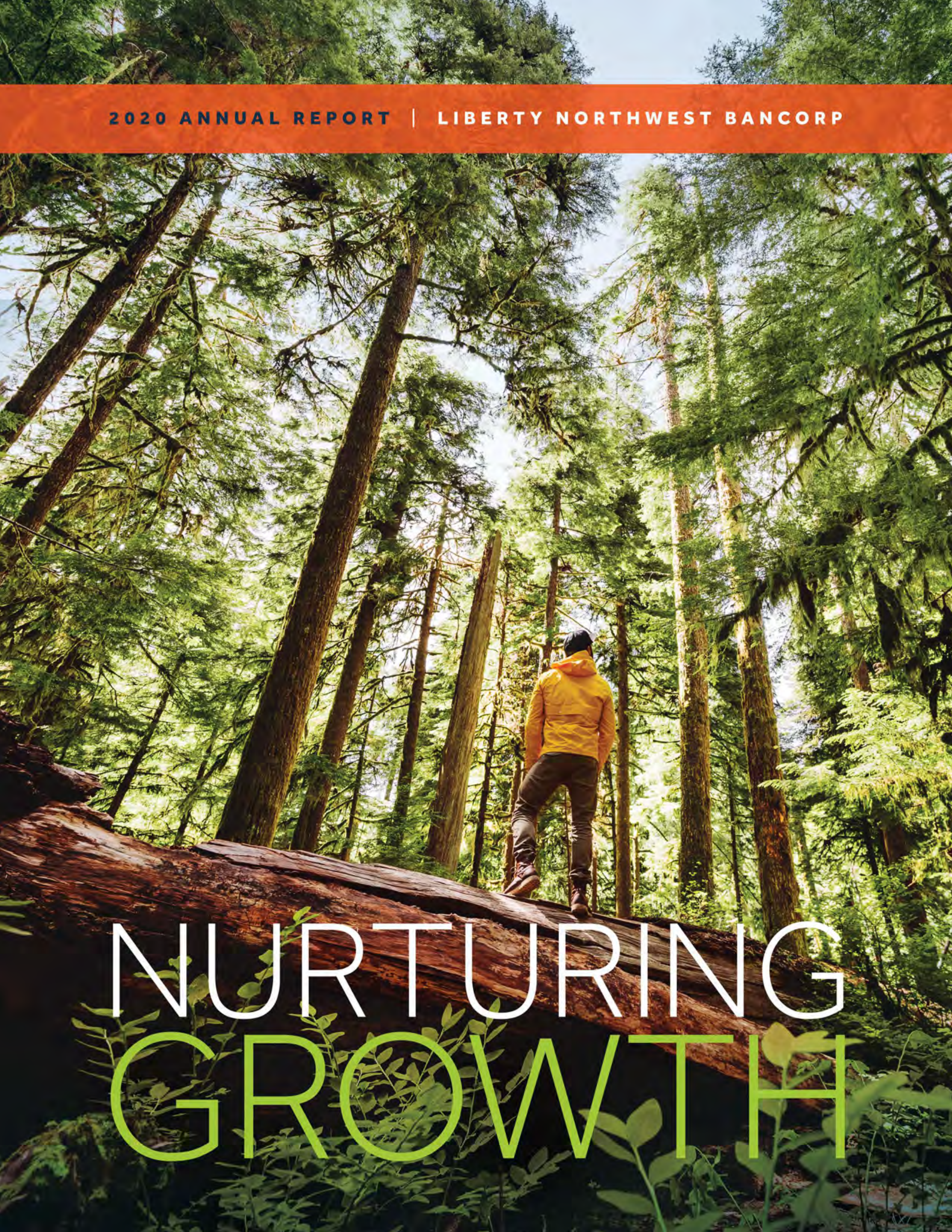
2020 ANNUAL REPORT | LIBERTY NORTHWEST BANCORP



# NURTURING GROWTH

THRIVE

BOARD OF DIRECTORS



TABLE OF CONTENTS

## DEAR SHAREHOLDERS, CLIENTS AND EMPLOYEES,

I am pleased to report we have continued to help our local business community by providing additional Paycheck Protection Program loans in this first quarter of 2021. As of February 28th, 2021, approximately $25 million in loans have been initiated for approval with the Small Business Administration (SBA).

As indicated earlier in 2020, despite a global pandemic and its impact on people's wellbeing and the economy, Liberty Bank continued to make significant progress in growth, quality, and market expansion for the year ending December 31, 2020. We hit many milestones as we served our valued Kitsap County community and attracted new customers across the Sound in Bellevue and the Eastside. Here are some of the key milestones we hit:

- Total Assets were $170.2 million on December 31, 2020, compared to $128.2 million on December 31, 2019. This was an **increase of $42.0 million or 32.8% during this annual period.** If we factor out the impact of Paycheck Protection Program (PPP) lending, assets on December 31, 2020, were $135.7 million, **an increase of $7.5 million or 5.8% during this annual period.**
- Gross Loans were $125.4 million on December 31, 2020, compared to $82.0 million on December 31, 2019, **a $43.4 million increase or 52.9% during this annual period.** If we exclude PPP loans of $34.5 million, **our annual loan growth would be $8.9 million or 10.9%.**
- Since the first round of the Small Business Administration's (SBA) PPP funding, Liberty Bank **has processed more than 500 applications** for existing and new clients, totaling **more than $70.0 million in PPP loans.**
- On December 31, 2020, the bank had **zero non-performing loans** and no loans with payments past due more than 30 days, something we are very proud of during these challenging economic times. While our credit quality performance continues to outperform our peers, Liberty Bank also set aside additional loan loss reserves of $331,000 during this annual period as a prudent measure during this time of economic stress.
- Net Interest Income (excluding PPP fees) **increased by $400,000 or 9.9%** despite the reduction in the Fed Funds rate during the year in response to the global pandemic. The increase in Net Interest Income is due to the increase in loan volume and a reduction in deposit rates. The bank's Net Interest Margin for this annual period is 3.76%.
- Net Income for Q4 ending December 31, 2020, was $98,000 with annual net income of $513,000. This compares to $148,000 of annual net income in 2019. This was an increase of $365,000 or 246.6%.
- Liberty Northwest Bancorp's book value per share increased to $7.63 for Q4 from $7.21 one year earlier.

**Liberty Northwest Bancorp is providing capital strength to Liberty Bank.** In my last correspondence, I noted that shareholders approved the formation of a new bank holding company. The goal of the bank holding company is to increase shareholder value and provide access to the capital markets. I am pleased to report that on March 23, Liberty Northwest Bancorp successfully issued $5 million in subordinated debt. These funds can be utilized as Tier I capital as they are injected into Liberty Bank.

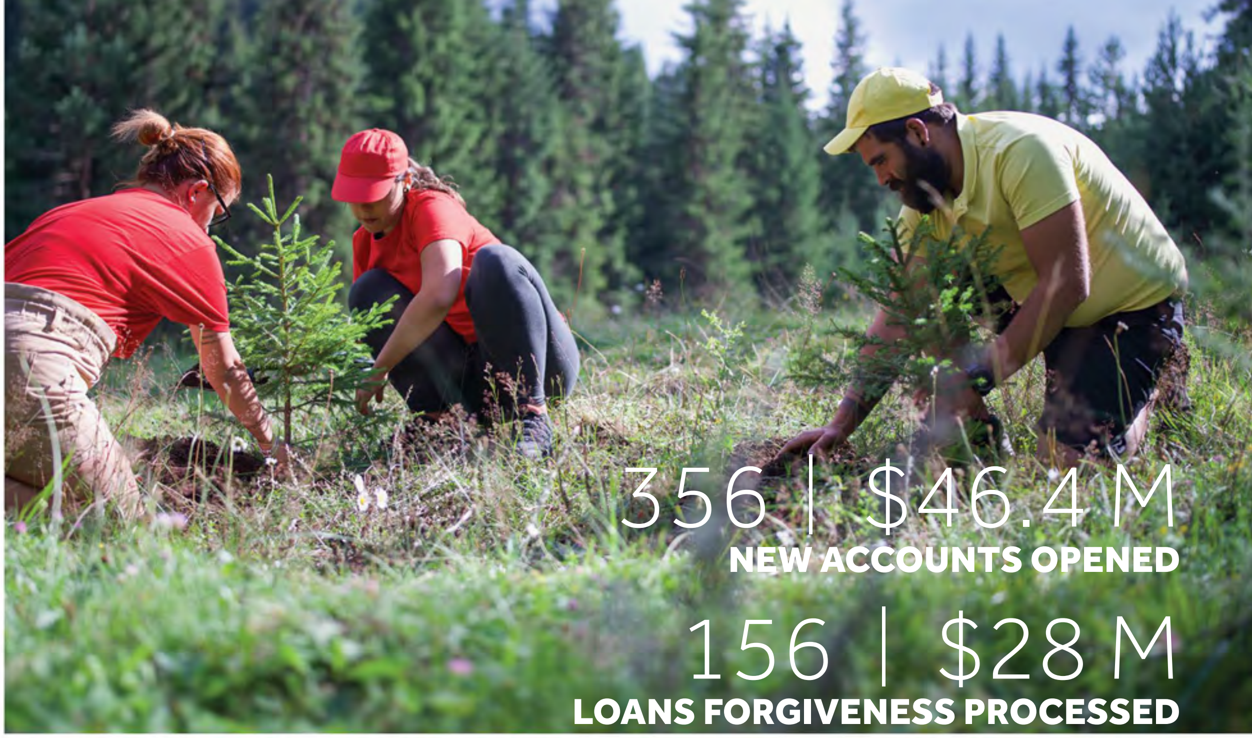
It is also important to recognize the amazing team of individuals who have been here at the bank over the last 10+ years. They have provided the vision and foundation for what we are building today. We are thankful for their continued effort and determination. They are truly the superstars in our community and bank. I am excited by our success and look forward to building on it in the future.

On behalf of the Board of Directors, and all Liberty Bank employees, we appreciate your continued support.

Rick Darrow

**RICK DARROW**
PRESIDENT | CEO
LIBERTY NORTHWEST BANCORP

SUSTAIN




## **GENERATING** SMALL BUSINESS GROWTH

**HERDMAN PLUMBING | SILVERDALE, WA** When longtime Liberty Bank customer Herdman Plumbing was forced to stop working on all construction projects in March because the state ordered the COVID-19 shutdown, the owners of the family business had to lay off 43 employees. They quickly turned to Liberty Bank for help applying for a PPP loan. Ultimately, they received two loans and loan forgiveness. "We got the loan the last week before we were able to open back up and were able to get our employees off of unemployment and pay them," said Haylee Herdman, whose husband Adam founded the company in 2006. "They were able to go to work the following week."

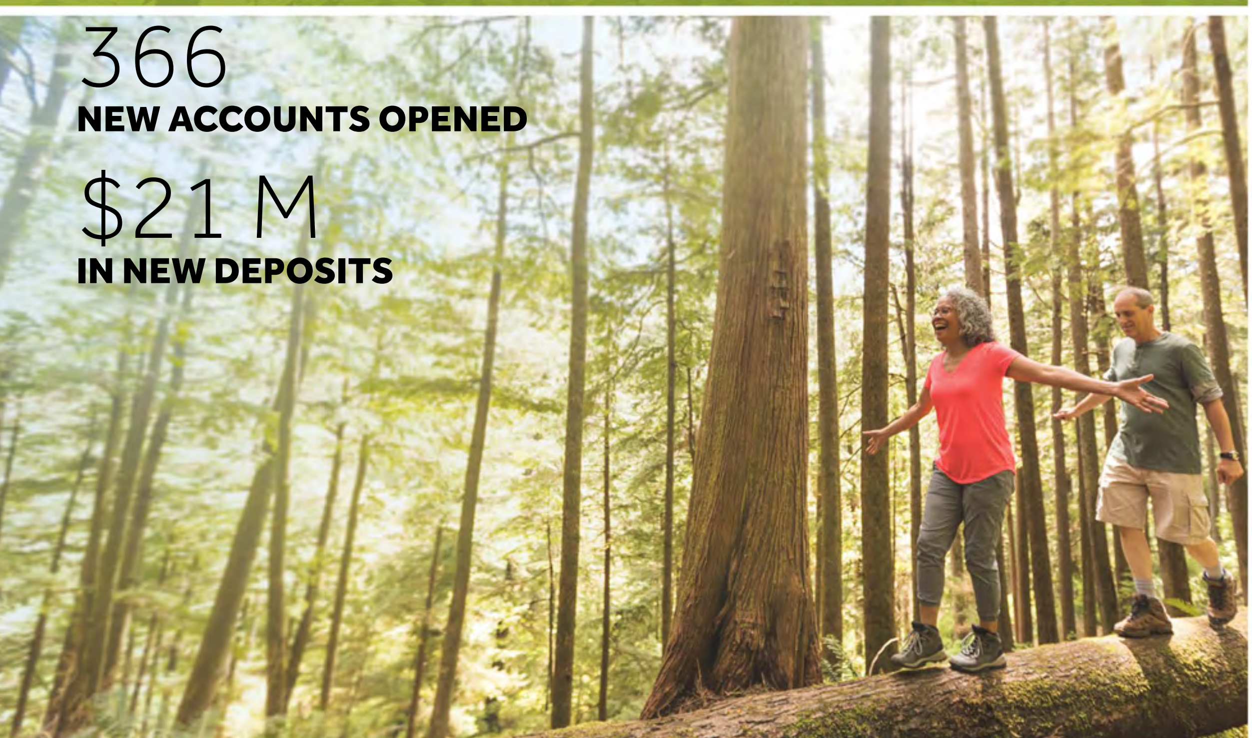
**KITSAP COMMUNITY FOUNDATION | SILVERDALE, WA** The PPP loans Liberty Bank helped secure for the Kitsap Community Foundation literally allowed the nonprofit organization to keep its eight employees working so they could continue to raise critical funds for more than 300 nonprofits that serve Kitsap County. "Like many nonprofits, we're reliant on fundraisers for operating support and we were not able to hold our largest fundraiser last May," said Shaine Schramling, the foundation's funds and grants officer. "To keep everything running smoothly, it was vital that we get some assistance. With so much uncertainty in the world, especially related to nonprofit organizations, we felt very grateful that the loan process with Liberty Bank was easy and not overly complicated." Because the foundation kept operating seamlessly, 2020 Kitsap Great Give fundraising exceeded 2019 fundraising by nearly $800,000 and additional money was distributed to nonprofits through the Kitsap Covid-19 Response Fund.

**EASTSIDE LEGAL ASSISTANCE PROGRAM | BELLEVUE, WA** After being turned down for PPP funding by two larger banks, the executive director of Eastside Legal Assistance Program learned from his wife that someone she knew through Bellevue Rotary was president of a small local bank that might be able to help. Jerry Kröon called Liberty Bank President Alan Fulp, who worked through the early morning hours of Easter Sunday to secure a PPP loan for the nonprofit organization that provides free legal assistance to victims of domestic violence. "I cried," Kröon said when Fulp called with the good news about the PPP loan. "It saved our organization. Without the loan we would have had to slash our budget, lay off people and would not have been able to serve clients."

ELAP

**SEATTLE ORAL CARE | SEATTLE, WA** Dentists Deepali Jere and Aruna Krishna first learned about Liberty Bank from their accountant when they had trouble securing their first PPP loan. The Liberty Bank team was quickly able to help the dental partnership secure a loan, which the dentists say kept the business stable during the challenging 2020 year. "Our business would have gone downhill for sure," Dr. Krishna said. She and Dr. Jere were so impressed with the Liberty Bank team, that they not only went back for a second PPP loan, but also sought and secured a conventional loan to buy out an existing partnership in a new part of the city they felt would allow them to grow even more in the future. "Working with Christina Beason and her team (Aleecia Poulsen, Angie Payne and Galina Georgieva) has been a really positive experience for us," Dr. Jere said. "Kudos to them. Christina believed in us and we needed someone who believed in us."

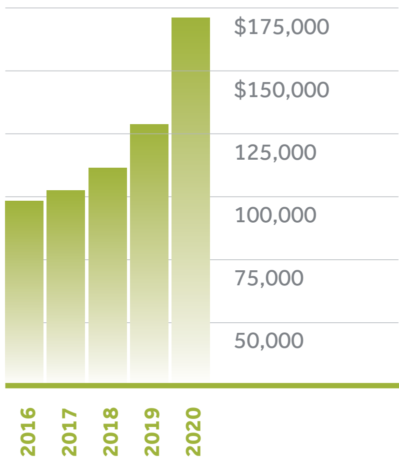
Seattle ORAL CARE



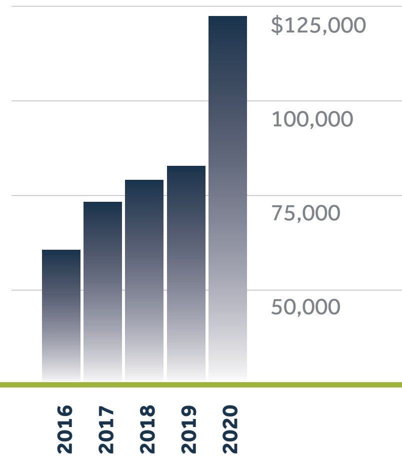

CULTIVATE

# FINANCIAL HIGHLIGHTS 2020

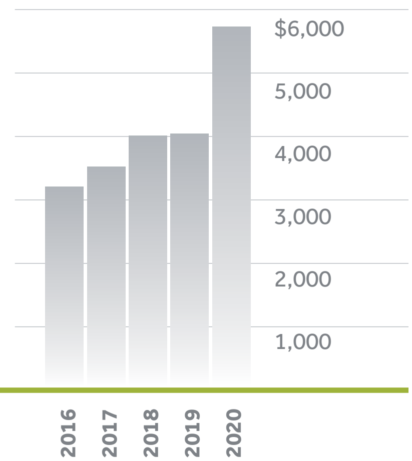
### TOTAL ASSETS




### TOTAL LOANS




### NET INTEREST INCOME




| AT DECEMBER 31 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| ASSETS | $ 96,840 | $103,310 | $115,478 | $128,227 | **$170,189** |
| LOANS | 61,562 | 72,311 | 78,980 | 81,766 | **124,868** |
| DEPOSITS | 68,205 | 78,743 | 92,400 | 104,317 | **125,686** |
| STOCKHOLDERS' EQUITY | 9,423 | 9,289 | 9,774 | 11,553 | **12,236** |

| FOR THE YEAR ENDED | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Net Interest Income | $ 3,243 | $3,569 | $4,023 | $4,059 | **$ 5,788** |
| Pre-tax Income | 398 | 424 | 679 | 189 | **650** |
| Net Income (Loss) | 1,228 | (294) | 527 | 148 | **513** |
| Noninterest Income | 267 | 112 | 285 | 201 | **348** |
| Noninterest Expense | 3,082 | 3,245 | 3,590 | 4,056 | **5,157** |

| KEY OPERATING RATIONS | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Return on Average Equity (pre-tax income) | 4.44% | 4.38% | 7.28% | 1.69% | **5.44%** |
| Return on Average Equity (net income) | 13.69% | -3.03% | 5.65% | 1.32% | **4.29%** |
| Return on Average Assets (pre-tax income) | 0.45% | 0.43% | 0.62% | 0.16% | **0.41%** |
| Return on Average Assets (net income) | 1.39% | -0.30% | 0.48% | 0.13% | **0.32%** |
| Net Interest Margin | 3.89% | 3.85% | 3.79% | 3.65% | **3.76%** |
| Non-interest Expense to Average Assets | 3.50% | 3.29% | 3.21% | 3.46% | **3.22%** |
| Ration of Non-performing Loans to Total Assets | 0.01% | 0.01% | 0.58% | 0.51% | **0.00%** |
| Net Loan Charge-offs to Average Loans | 0.00% | 0.01% | 0.01% | 0.00% | **-0.01%** |

| CAPITAL RATIOS | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Leverage | 9.44% | 9.21% | 8.55% | 9.36% | **8.20%** |
| Total Risk Based | 14.32% | 13.96% | 13.66% | 15.67% | **15.47%** |

# REPORT OF INDEPENDENT AUDITORS

**TO THE BOARD OF DIRECTORS AND SHAREHOLDERS**
**LIBERTY NORTHWEST BANCORP, INC.**

## REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated financial statements of Liberty Northwest Bancorp, Inc. and Subsidiary, which comprise the balance sheets as of December 31, 2020 and 2019, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

## MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Liberty Northwest Bancorp, Inc. as of December 31, 2020 and 2019, 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 31, 2021

## CONSOLIDATED BALANCE SHEETS

(DOLLARS IN THOUSANDS)

| ASSETS | DECEMBER 31, 2020 | DECEMBER 31, 2019 |
|---|---|---|
| CASH AND CASH EQUIVALENTS | | |
| Cash and due from banks | $ 3,594 | $ 3,218 |
| Overnight funds | 30,205 | 27,485 |
| Total cash and cash equivalents | 33,799 | 30,703 |
| INTEREST-BEARING DEPOSITS WITH OTHER FINANCIAL INSTITUTIONS | 19 | 495 |
| INVESTMENT SECURITIES AVAILABLE-FOR-SALE, at fair value | 6,338 | 9,385 |
| INVESTMENT SECURITIES HELD-TO-MATURITY, at amortized cost | 3,132 | 3,077 |
| FEDERAL HOME LOAN BANK STOCK, at cost | 394 | 619 |
| LOANS | 124,868 | 81,766 |
| Less allowance for credit losses | 1,125 | 788 |
| Total loans, net | 123,743 | 80,978 |
| PREMISES AND EQUIPMENT, net | 1,205 | 1,510 |
| ACCRUED INTEREST RECEIVABLE | 648 | 341 |
| OTHER ASSETS | 911 | 1,119 |
| Total assets | **$ 170,189** | **$ 128,227** |

| LIABILITIES AND SHAREHOLDERS' EQUITY | 2020 | 2019 |
|---|---|---|
| DEPOSITS | | |
| Noninterest-bearing | $ 51,537 | $ 27,059 |
| Interest-bearing | 74,149 | 77,258 |
| Total deposits | 125,686 | 104,317 |
| Borrowed funds | 31,149 | 12,000 |
| ACCRUED INTEREST PAYABLE | 62 | 13 |
| OTHER LIABILITIES | 1,056 | 344 |
| Total liabilities | 157,953 | 116,674 |
| SHAREHOLDERS' EQUITY | | |
| Common stock, $1 par value, 10,000,000 shares authorized, 1,616,419 and 1,601,419 shares issued and outstanding at December 31, 2020 and 1,624,419 and 1,602,419 issued and outstanding at December 31, 2019 | 1,601 | 1,602 |
| Additional paid-in capital | 12,853 | 12,851 |
| Accumulated deficit | (2,286) | (2,799) |
| Accumulated other comprehensive income (loss) | 68 | (101) |
| Total shareholders' equity | 12,236 | 11,553 |
| Total liabilities and shareholders' equity | **$ 170,189** | **$ 128,227** |

See accompanying notes

## CONSOLIDATED STATEMENTS OF INCOME

(DOLLARS IN THOUSANDS)

| | DECEMBER 31, 2020 | DECEMBER 31, 2019 |
|---|---|---|
| INTEREST AND FEE INCOME | | |
| Loans, including fees | $ 6,209 | $ 4,583 |
| Investments | 145 | 307 |
| Interest-bearing deposits with other financial institutions and overnight funds | 66 | 228 |
| Total interest and fee income | 6,420 | 5,118 |
| INTEREST EXPENSE | | |
| Deposits | 443 | 922 |
| Borrowed funds | 189 | 137 |
| Total interest expense | 632 | 1,059 |
| NET INTEREST INCOME | 5,788 | 4,059 |
| PROVISION FOR CREDIT LOSSES | 329 | 15 |
| NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES | 5,459 | 4,044 |
| NONINTEREST INCOME | | |
| Service charges on deposits | 39 | 58 |
| Debit and credit card interchange income, net | 44 | 40 |
| Gain (loss) on sale of securities available-for-sale | 29 | (43) |
| Other income | 236 | 146 |
| Total noninterest income | 348 | 201 |
| NONINTEREST EXPENSE | | |
| Salaries and employee benefits | 3,038 | 2,367 |
| Occupancy and equipment | 683 | 544 |
| Data processing | 539 | 415 |
| Advertising and business development | 72 | 70 |
| Professional and regulatory | 301 | 207 |
| Other expenses | 524 | 453 |
| Total noninterest expense | 5,157 | 4,056 |
| NET INCOME BEFORE PROVISION FOR INCOME TAXES | 650 | 189 |
| PROVISION FOR INCOME TAXES | 137 | 41 |
| NET INCOME | **$ 513** | **$ 148** |

See accompanying notes

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(DOLLARS IN THOUSANDS)

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | **2020** | **2019** |
| NET INCOME | $ 513 | $ 148 |
| Other comprehensive income | | |
| Unrealized gain (loss) on securities available-for-sale | | |
| Unrealized holding gain (loss) | 243 | 540 |
| Tax benefit (expense) on unrealized holding gain (loss) | (51) | (113) |
| Reclassification adjustments for realized (gain) loss on sales of securities available-for-sale | (29) | 43 |
| Tax expense (benefit) for realized gain and (losses) on sales | 6 | (9) |
| Other comprehensive income | 169 | 461 |
| COMPREHENSIVE INCOME | **$ 682** | **$ 609** |

See accompanying notes

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(DOLLARS IN THOUSANDS)

| | Common Stock | | Additional Paid-in | Accumulated | Accumulated Other Comprehensive | Total Shareholders' |
|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Deficit | Income (Loss) | Equity |
| **BALANCE, December 31, 2018** | 1,435,582 | $ 1,436 | $11,847 | $ (2,947) | $ (562) | $ 9,774 |
| Net income | – | – | – | 148 | – | 148 |
| Proceeds from stock issuance, net | 160,666 | 160 | 960 | – | – | 1,120 |
| Exercise of options (cashless) | 171 | – | – | – | – | – |
| Issuance of restricted stock | 30,000 | – | – | – | – | – |
| Vesting of restricted stock | – | 6 | (6) | – | – | – |
| Other comprehensive income, net | – | – | – | – | 461 | 461 |
| Stock-based compensation | – | – | 50 | – | – | 50 |
| **BALANCE, December 31, 2019** | 1,626,419 | 1,602 | 12,851 | (2,799) | (101) | 11,553 |
| Net income | – | – | – | 513 | – | 513 |
| Repurchase of shares | (7,000) | (7) | (42) | – | – | (49) |
| Vesting of restricted stock | – | 6 | (6) | – | – | – |
| Other comprehensive income, net | – | – | – | – | 169 | 169 |
| Stock-based compensation | – | – | 50 | – | – | 50 |
| **BALANCE, December 31, 2020** | **1,619,419** | **$ 1,601** | **$12,853** | **$ (2,286)** | **$ 68** | **$12,236** |

See accompanying notes

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(DOLLARS IN THOUSANDS)

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | **2020** | **2019** |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $ 513 | $ 148 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Provision for credit losses | 329 | 15 |
| Depreciation and amortization | 178 | 184 |
| Deferred expense for income taxes | 137 | 41 |
| Net amortization of investment security premium/discount | 65 | 74 |
| Stock-based compensation | 50 | 50 |
| (Gain) loss on sale of investment securities | (29) | 43 |
| Gain on sale of building | (64) | – |
| Changes in operating assets and liabilities | | |
| Accrued interest receivable | (307) | 9 |
| Other assets | 25 | (24) |
| Accrued interest payable | 49 | 2 |
| Other liabilities | 712 | 51 |
| Net cash provided by operating activities | 1,658 | 593 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Net change in interest-bearing deposits with other financial institutions | 476 | (131) |
| Activity in securities available-for-sale | | |
| Maturities, prepayments, and calls | 2,125 | 2,854 |
| Sales | 3,327 | 4,485 |
| Purchases | (2,212) | (552) |
| Activity in securities held-to-maturity | | |
| Maturities, prepayments, and calls | 687 | 480 |
| Purchases | (757) | – |
| Redemption of Federal Home Loan Bank stock | 225 | 25 |
| Loan originations, net | (43,094) | (2,786) |
| Sale of premises and equipment | 1,201 | – |
| Purchase of premises and equipment | (1,010) | (72) |
| Net cash used in investing activities | (39,032) | 4,303 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in deposits | 21,370 | 11,917 |
| Proceeds from Paycheck Protection Program Liquidity Facility, net | 25,149 | – |
| Proceeds from advances from the Federal Home Loan Bank | 1,500 | 1,500 |
| Repayments of advances from the Federal Home Loan Bank | (2,500) | (2,500) |
| Repayment of overnight advances, net | (5,000) | – |
| Repurchase of stock | (49) | – |
| Proceeds from stock issuance | – | 1,120 |
| Net cash received from financing activities | 40,470 | 12,037 |
| NET CHANGE IN CASH AND CASH EQUIVALENTS | 3,096 | 16,933 |
| CASH AND CASH EQUIVALENTS, beginning of year | 30,703 | 13,770 |
| CASH AND CASH EQUIVALENTS, end of year | **$ 33,799** | **$ 30,703** |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION | | |
| Cash paid during the year for interest | **$ 1,010** | **$ 1,058** |
| NONCASH INVESTING AND FINANCING ACTIVITIES | | |
| Unrealized gain on securities available-for-sale | **$ 214** | **$ 583** |

See accompanying notes

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(DOLLARS IN THOUSANDS)

### NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**NATURE OF OPERATIONS** – Liberty Northwest Bancorp, Inc. (the Company) is a bank holding company whose wholly owned subsidiary is Liberty Bank (the Bank). The Bank provides a full range of banking services to individual and corporate customers through its main office in Poulsbo, Washington, a leased space in Bellevue, Washington. 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.

**STATEMENT PRESENTATION AND USE OF ESTIMATES** – The consolidated 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 consolidated 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.

**PRINCIPLES OF CONSOLIDATION** – The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany accounts have been eliminated in consolidation.

**SUBSEQUENT EVENTS** – Subsequent events are events or transactions that occur after the date of the balance sheet but before consolidated 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 consolidated 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 31, 2021, the date the consolidated financial statements were available to be issued.

On March 23, 2021 (the closing date), Liberty Northwest Bancorp, Inc. issued four unsecured subordinated term notes (the subordinated notes) with an aggregate principal amount of $5 million, maturing April 1, 2031, pursuant to subordinated loan agreements with various investors. The subordinated notes bear interest at an annual interest rate of 5.50% for a fixed rate period from the closing date to March 31, 2026, payable by the Company semi-annually in arrears. From April 1, 2026, through the maturity date, there is a floating rate period where the notes bear interest at an annual interest rate of the greater of 5.50%, payable semi-annually, in arrears, or a floating interest rate based on the 90-day average Secured Overnight Financing Rate plus 500 basis points, payable quarterly, in arrears. Debt issuance costs were not significant.

## NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**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 original 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 purchased 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.

**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, 2020 or 2019.

**INVESTMENTS** – Investment debt 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 debt securities are classified as available-for-sale when they might be sold before maturity. 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 any 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 debt 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).

## NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**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, 2020 or 2019.

**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, 2020 or 2019.

**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.

In conjunction with the passage of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) in March 2020, financial institutions have been provided the option, for loans meeting specific criteria, to temporarily suspend certain requirements under GAAP related to Troubled Debt Restructurings (TDRs) for a limited time to assist borrowers experiencing financial hardship due to the COVID-19 Pandemic (the Pandemic). As a result, the Bank has not recognized eligible CARES Act loan modifications as TDRs.

Additionally, loans qualifying for these modifications are not required to be reported as delinquent, nonaccrual, impaired or criticized solely as a result of loan modification resulting from the economic effects of the Pandemic. Modifications include deferral of payments and interest only periods. The Bank accrues and recognizes interest income on loans under payment relief based on the original contractual interest rates. When payments resume at the end of the relief period, the payments will generally be applied to accrued interest due until accrued interest is fully paid. Accrued interest balances are assessed for collectability on a periodic basis. As of December 31, 2020, there were no loans in deferral under a CARES Act modification agreement, as all loans had resumed scheduled payments.

## NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**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.

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 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 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.

### NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

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 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.

**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.

## NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**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 consolidated 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 $6 and $18 in 2020 and 2019, 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, 2020 and 2019, are included within the statements of comprehensive income.

**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.

## NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**REVENUE RECOGNITION** – On January 1, 2019, the Bank adopted Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and all subsequent amendments to the ASU (collectively, ASC 606), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Bank performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Bank satisfies a performance obligation. The majority of the Bank's revenues come from interest income, including loans and securities that are outside the scope of ASC 606. The Company's services that fall within the scope of ASC 606 are presented within noninterest income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit service charges and interchange fee income and expenses.

The Bank adopted ASC 606 using the modified retrospective method applied to all contracts not completed as of January 1, 2019. Results for reporting periods beginning on or after January 1, 2019, are presented under ASC 606, while prior period amounts continue to be reported in accordance with legacy GAAP.

**SERVICE CHARGES ON DEPOSIT ACCOUNTS** – The Bank earns fees from its deposit customers for account maintenance, transaction-based activity, and overdraft services. Account maintenance fees consist primarily of account fees and analyzed account fees charged on deposit accounts on a monthly basis. The performance obligation is satisfied and the fees are recognized on a monthly basis as the service period is completed. Transaction-based fees on deposit accounts are charged to deposit customers for specific services provided to the customer, such as non-sufficient funds fees, overdraft fees, and wire fees. The performance obligation is completed as the transaction occurs and the fees are recognized at the time each specific service is provided to the customer.

**DEBIT AND ATM INTERCHANGE FEE INCOME AND EXPENSES** – Debit and ATM interchange income represent fees earned when a debit card issued by the Company is used. The Company earns interchange fees from debit cardholder transactions through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. The performance obligation is satisfied and the fees are earned when the cost of the transaction is charged to the cardholders' debit card. Certain expenses directly associated with the debit card are recorded on a net basis with the interchange income.

**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.

(DOLLARS IN THOUSANDS)

### NOTE 2 – INVESTMENTS

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

| **December 31, 2020** | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Available-for-sale | | | | |
| Collateralized mortgage obligation securities | $ 1,956 | $ 1 | $ (3) | $ 1,954 |
| Mortgage-backed securities | $ 4,296 | $ 88 | $ – | $ 4,384 |
| Total | $ 6,252 | $ 89 | $ (3) | $ 6,338 |
| Held-to-maturity | | | | |
| Mortgage-backed securities | $ 2,758 | $ 78 | $ – | $ 2,836 |
| SBA security | 374 | 29 | – | 403 |
| Total | $ 3,132 | $ 107 | $ – | $ 3,239 |
| **December 31, 2019** | | | | |
| Available-for-sale | | | | |
| Mortgage-backed securities | $ 9,513 | $ 2 | $ (130) | $ 9,385 |
| Held-to-maturity | | | | |
| Mortgage-backed securities | $ 2,658 | $ 2 | $ (26) | $ 2,634 |
| SBA security | 419 | 8 | – | 427 |
| Total | $ 3,077 | $ 10 | $ (26) | $ 3,061 |

The amortized cost and estimated fair value of investment securities at December 31, 2020, 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 1 to 5 years | $ 607 | $ 618 | $ – | $ – |
| Due after 5 to 10 years | 187 | 196 | – | – |
| Due after 10 years | 5,458 | 5,524 | 3,132 | 3,239 |
| | $ 6,252 | $ 6,338 | $ 3,132 | $ 3,239 |

As of December 31, 2020, securities with a carrying value of $5,852 were pledged to secure borrowings at the FHLB and securities with a carrying value of $1,385 were pledged to secure public deposits. As of December 31, 2019, securities with a carrying value of $9,086 were pledged to secure borrowings at the FHLB and securities with a carrying value of $3,376 were pledged to secure public deposits.

(DOLLARS IN THOUSANDS)

### NOTE 2 – INVESTMENTS (CONTINUED)

During the year ended December 31, 2020, the Bank sold eleven investment securities totaling $3,327, with gross gains of $29 recognized on the sales. During the year ended December 31, 2019, the Bank sold nine investment securities totaling $4,485, with gross losses of $43 recognized on the sales.

At December 31, 2020 and 2019, 1 and 29 securities were in an unrealized loss position, with 0 and 26 in a loss position of more than 12 months, respectively. 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 being required to sell these securities in the near term, no declines are deemed to be other than temporary.

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, 2020** | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Total Unrealized Losses |
| Securities available-for-sale | | | | | |
| Collateralized mortgage obligation securities | $ 3 | $ 936 | $ – | $ – | $ 3 |
| | | | | | |
| **December 31, 2019** | | | | | |
| Securities available-for-sale | | | | | |
| Mortgage-backed securities | $ 4 | $ 784 | $ 126 | $ 7,710 | $ 130 |
| Held-to-maturity | | | | | |
| Mortgage-backed securities | $ – | $ – | $ 26 | $ 1,408 | $ 26 |

(DOLLARS IN THOUSANDS)

### NOTE 3 – LOANS AND ALLOWANCE FOR CREDIT LOSSES

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

| | 2020 | 2019 |
|---|---|---|
| Commercial real estate | $ 38,104 | $ 38,989 |
| Commercial | 45,109 | 16,074 |
| Construction and land | 4,168 | 7,127 |
| Consumer | 4,589 | 206 |
| Residential real estate | 33,433 | 19,630 |
| Gross loans | 125,403 | 82,026 |
| Deferred fees and costs, net | (535) | (260) |
| Allowance for credit losses | (1,125) | (788) |
| Total loans, net | $ 123,743 | $ 80,978 |

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed by the President of the United States. During the year ended December 31, 2020, the Bank participated in the Paycheck Protection Program (PPP), under the CARES Act, whereby loans to small businesses are made and those loans are subject to the regulatory requirements that would require forbearance of loan payments for a specified time or that would limit the ability to pursue all available remedies in the event of a loan default. The above table includes $34,456 of PPP loans administered by the U.S. Small Business Administration (SBA) within the Commercial loan segment as of December 31, 2020.

The Bank pledged certain commercial loans as collateral for purposes of borrowings with the FHLB. Loans totaling $41,624 and $34,065 were pledged to the FHLB at December 31, 2020 and 2019, respectively (Note 6).

(DOLLARS IN THOUSANDS)

### NOTE 3 – LOANS AND ALLOWANCE FOR CREDIT LOSSES (CONTINUED)

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

| **2020** | Beginning Balance | Provision (Recovery) for Credit Losses | Charge-offs | Recoveries | Ending Balance |
|---|---|---|---|---|---|
| Commercial real estate | $ 411 | 96 | $ – | $ – | $ 507 |
| Commercial | 116 | (3) | – | (8) | 105 |
| Construction and land | 60 | (48) | – | – | 12 |
| Consumer | 1 | 73 | – | – | 74 |
| Residential real estate | 134 | 261 | – | – | 395 |
| Unallocated | 66 | (34) | – | – | 32 |
| | $ 788 | $ 345 | $ – | $ (8) | $ 1,125 |
| **2019** | | | | | |
| Commercial real estate | $ 418 | (7) | $ – | $ – | $ 411 |
| Commercial | 76 | 40 | – | – | 116 |
| Construction and land | 130 | (70) | – | – | 60 |
| Consumer | 1 | – | – | – | 1 |
| Residential real estate | 74 | 60 | – | – | 134 |
| Unallocated | 74 | (8) | – | – | 66 |
| | $ 773 | $ 15 | $ – | $ – | $ 788 |

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

| **2020** | 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 real estate | $ – | $ – | $ – | $ 932 | $ – |
| Commercial | – | – | – | 302 | – |
| | $ – | $ – | $ – | $ 1,234 | $ – |
| **2019** | | | | | |
| With no allowance recorded | $ 1,865 | $ 1,865 | $ – | $ 933 | $ 107 |
| Commercial real estate | 603 | 603 | – | – | – |
| Commercial | $ 2,468 | $ 2,468 | $ – | $ 933 | $ 107 |

(DOLLARS IN THOUSANDS)

### NOTE 3 – LOANS AND ALLOWANCE FOR CREDIT LOSSES (CONTINUED)

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 | | |
|---|---|---|---|---|---|---|
| **2020** | 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 | $ 507 | – | $ 507 | $ 38,104 | $ – | $ 38,104 |
| Commercial | 105 | – | 105 | 45,109 | – | 45,109 |
| Construction and land | 12 | – | 12 | 4,168 | – | 4,168 |
| Consumer | 74 | – | 74 | 4,589 | – | 4,589 |
| Residential real estate | 395 | – | 395 | 33,433 | – | 33,433 |
| Unallocated | 32 | – | 32 | – | – | – |
| | $ 1,125 | $ – | $ 1,125 | $125,403 | $ – | $125,403 |
| **2019** | | | | | | |
| Commercial real estate | $ 411 | – | $ 411 | $ 38,989 | $ 1,865 | $ 37,124 |
| Commercial | 116 | – | 116 | 16,074 | 603 | 15,471 |
| Construction and land | 60 | – | 60 | 7,127 | – | 7,127 |
| Consumer | 1 | – | 1 | 206 | – | 206 |
| Residential real estate | 134 | – | 134 | 19,630 | – | 19,630 |
| Unallocated | 66 | – | 66 | – | – | – |
| | $ 788 | $ – | $ 788 | $ 82,026 | $ 2,468 | $ 79,558 |

(DOLLARS IN THOUSANDS)

**NOTE 3 – LOANS 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:

| **2020** | 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 | $ – | $ – | $ – | $ – | $ 38,104 | $ 38,104 |
| Commercial | – | – | – | – | 45,109 | 45,109 |
| Construction and land | – | – | – | – | 4,168 | 4,168 |
| Consumer | – | – | – | – | 4,589 | 4,589 |
| Residential real estate | – | – | – | – | 33,433 | 33,433 |
| | $ – | $ – | $ – | $ – | $125,403 | $125,403 |

| **2019** | 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 | $ – | $ 597 | $ 578 | $ 1,175 | $ 37,814 | $ 38,989 |
| Commercial | – | – | 75 | 75 | 15,999 | 16,074 |
| Construction and land | – | – | – | – | 7,127 | 7,127 |
| Consumer | – | – | – | – | 206 | 206 |
| Residential real estate | – | – | – | – | 19,630 | 19,630 |
| | $ – | $ 597 | $ 653 | $ 1,250 | $ 80,776 | $ 82,026 |

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.

The following table presents the recorded investment in nonaccrual loans at December 31:

| | 2020 | 2019 |
|---|---|---|
| Commercial real estate | $ – | $ 578 |
| Commercial | – | 75 |
| | $ – | $ 653 |

There were no loans 90 days or more past due and still accruing interest at December 31, 2020 or 2019.

**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.

(DOLLARS IN THOUSANDS)

**NOTE 3 – LOANS AND ALLOWANCE FOR CREDIT LOSSES** (CONTINUED)

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, 2020, the Bank had no loans classified as doubtful or loss.

The following tables represent the credit risk profile by internally assigned grade and performing status as of December 31, 2020 and 2019, by class of loans:

**Credit Risk Profile by Internally Assigned Grade**

| **2020** | Commercial Real Estate | Commercial | Construction and Land | Consumer | Residential Real Estate | Total |
|---|---|---|---|---|---|---|
| Grade | | | | | | |
| Pass | $ 34,304 | $ 43,359 | $ 4,168 | $ 4,560 | $ 32,926 | $119,317 |
| Watch | 3,800 | 1,750 | | 29 | 97 | 5,676 |
| Special mention | – | – | – | – | 410 | 410 |
| Substandard | – | – | – | – | – | – |
| Doubtful | – | – | – | – | – | – |
| | $ 38,104 | $ 45,109 | $ 4,168 | $ 4,589 | $ 33,433 | $125,403 |

| **2019** | Commercial Real Estate | Commercial | Construction and Land | Consumer | Residential Real Estate | Total |
|---|---|---|---|---|---|---|
| Grade | | | | | | |
| Pass | $ 34,170 | $ 15,786 | $ 6,599 | $ 172 | $ 19,630 | $ 76,357 |
| Watch | 3,054 | 213 | | 34 | – | 3,301 |
| Special mention | – | – | – | – | – | – |
| Substandard | 1,765 | 75 | 528 | – | – | 2,368 |
| Doubtful | – | – | – | – | – | – |
| | $ 38,989 | $ 16,074 | $ 7,127 | $ 206 | $ 19,630 | $ 82,026 |

There were no loans modified by the Bank as troubled debt restructurings at December 31, 2020 and 2019, or modified during the years then ended

(DOLLARS IN THOUSANDS)

### NOTE 4 – PREMISES AND EQUIPMENT

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

| | 2020 | 2019 |
|---|---|---|
| Land | $ 673 | $ 132 |
| Building | – | 1,292 |
| Leasehold improvements | 769 | 713 |
| Furniture, fixtures, and office equipment | 723 | 620 |
| Vehicles | 23 | 23 |
| Construction in progress | 268 | 8 |
| | 2,456 | 2,788 |
| Less accumulated depreciation and amortization | (1,251) | (1,278) |
| | $ 1,205 | $ 1,510 |

The Bank leases 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. During the year, the Bank purchased a piece of land adjacent to the main office for the purpose of building a new headquarters. Additionally, the Bank executed a sublease agreement in Bellevue, Washington, effective November 2019 with terms extending through January 2022. The annual lease payments through both lease agreements outlined above are as follows:

| | |
|---|---|
| 2021 | $ 274 |
| 2022 | 13 |
| | $ 287 |

Rental expense, including operating expenses charged to operations, was $442 and $310 for the years ended December 31, 2020 and 2019, respectively.

During 2020, the Bank continued to lease a portion of the Port Orchard loan production office. The lease included an option by the tenant to purchase the building, which was exercised in June 2020. During the option term, a portion of lease payments per year were deferred from rental income and applied to the purchase price upon exercising the option. Total proceeds for the sale to the Bank was $1,201, and a gain on sale of $64 was recorded within other income on the consolidated statements of income.

(DOLLARS IN THOUSANDS)

### NOTE 5 – DEPOSITS

Deposits as of December 31 consisted of the following:

| | 2020 | 2019 |
|---|---|---|
| Savings accounts | $ 10,013 | $ 8,054 |
| Certificates of deposit | 6,782 | 14,905 |
| Demand accounts | | |
| Noninterest-bearing | 51,537 | 27,059 |
| Interest-bearing | 17,237 | 12,821 |
| Money market accounts | 40,117 | 41,478 |
| | $ 125,686 | $ 104,317 |

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

| | |
|---|---|
| 2021 | $ 6,468 |
| 2022 | 311 |
| 2023 | – |
| 2024 | – |
| 2025 | 3 |
| Total | $ 6,782 |

The Bank had $2,865 and $5,229 of certificates of deposit that met or exceeded the $250,000 federally insured limit at December 31, 2020 and 2019, respectively.

### NOTE 6 – CREDIT ARRANGEMENTS

At December 31, 2020, committed line-of-credit agreements totaling approximately $10.0 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 balance is included in cash and cash equivalents at December 31, 2020.

The Bank also utilized the Federal Reserve Bank's Paycheck Protection Program Liquidity Facility (the PPPLF) to fund PPP loans during the year ended December 31, 2020. These advances had an interest rate of 0.35%. The Company has not obtained any other new borrowing lines or other new sources of liquidity other than the PPPLF program during the year ended December 31, 2020. The Company had $25,149 outstanding in PPPLF as of December 31, 2020, which mature in April 2022, and has pledged with loans as required by the terms of the PPPLF.

(DOLLARS IN THOUSANDS)

## NOTE 6 – CREDIT ARRANGEMENTS (CONTINUED)

The Bank is a member of the FHLB of Des Moines, and as such, is eligible for a credit line up to 45% of total assets, subject to certain collateral requirements. At December 31, 2020, loans and investments pledged as collateral to the FHLB equated to a borrowing capacity of $35,393, 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, 2020, the Bank had $6,000 of long-term advances outstanding with the FHLB with a weighted-average rate of 2.35%. Current borrowings are collateralized by pledged investment securities (Note 3) and loans (Note 4). The excess balance of all collateral can be used for additional borrowings.

The contractual maturities of long-term FHLB advances at December 31, 2020, are as follows:

| | |
|---|---|
| 2021 | $ 2,000 |
| 2022 | 1,500 |
| 2023 | 1,000 |
| 2024 | 1,000 |
| 2025 | 500 |
| | $ 6,000 |

## NOTE 7 – INCOME TAXES

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

| | 2020 | 2019 |
|---|---|---|
| Deferred | $ 137 | $ 41 |
| Current | – | – |
| Total tax expense | $ 137 | $ 41 |

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

| | 2020 | | 2019 | |
|---|---|---|---|---|
| | Amount | Percent of Pre-Tax Income | Amount | Percent of Pre-Tax Income |
| Income tax at statutory rates | $ 136 | 21% | $ 40 | 21% |
| Increase resulting from | | | | |
| Permanent differences | 1 | 0% | 1 | 1% |
| Total income tax expense | $ 137 | 21% | $ 41 | 22% |

(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:

| | 2020 | 2019 |
|---|---|---|
| Deferred tax assets | | |
| Net operating loss carryforward | $ 91 | $ 410 |
| Organization expenditures | 65 | 84 |
| Property and equipment depreciation | 26 | 32 |
| Unrealized loss on securities | – | 27 |
| Other, net | 24 | 21 |
| Cash basis method of accounting | 45 | – |
| Allowance for credit losses | 224 | 155 |
| Subtotal | 475 | 729 |
| Deferred tax liabilities | | |
| Unrealized gain on securities | 18 | – |
| Cash basis method of accounting | – | 82 |
| Deferred costs | 18 | 26 |
| Subtotal | 36 | 108 |
| Net deferred tax asset | $ 439 | $ 621 |

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, 2020 and 2019.

On March 27, 2020, CARES Act was enacted in response to the COVID-19 pandemic. The CARES Act, among other things, permits NOL carryovers and carrybacks to offset 100% of taxable income for taxable years beginning before 2021. In addition, the CARES Act allows NOLs incurred in 2018, 2019, and 2020 to be carried back to each of the five preceding taxable years to generate a refund of previously paid income taxes. The Company has evaluated the impact of the CARES Act and determined that none of the changes would result in a material income tax benefit to the Company.

On December 27, 2020, the Consolidated Appropriations Act, 2021 was signed into law and extends several provisions of the CARES Act. As of December 31, 2020, the Company has determined that neither this Act nor changes to income tax laws or regulations in other jurisdictions have a significant impact on our effective tax rate.

At December 31, 2020, the Bank has, for tax reporting purposes, a net operating loss carryforward totaling approximately $430, eligible to offset future federal income taxes. The net operating loss carryforward will begin to expire in 2032.

### NOTE 7 – INCOME TAXES (CONTINUED)

At December 31, 2020, the Bank had unamortized preopening expenditures of approximately $308 (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.

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 2017.

### NOTE 8 – EMPLOYEE BENEFIT PLANS

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. In addition, the Bank has elected discretionary contributions under the 401(k) plan. Contributions vest at 20% per year after the first year and will be fully vested after six years of service. There were no discretionary contributions for the years ended December 31, 2020 and 2019.

### NOTE 9 – STOCK-BASED COMPENSATION

The Bank has an equity incentive plan (the Plan). 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. During the year ended December 31, 2019, the Plan expired. In 2020, shareholders approved the Liberty Bank 2020 Equity Incentive plan (the 2020 Plan), which permits the grant of incentive stock options, nonqualified stock options, and restricted stock awards to certain key employees and directors, at the discretion of the Board Governance Committee of the Bank. The 2020 Plan authorizes the Bank to grant up to 48,610 shares of common stock, subject to change through an annual review by the Board, provided the total number of shares available for issuance under the 2020 Plan do not exceed 650,000. As of December 31, 2020, the number of shares available to grant was 48,610. The 2020 Plan limits the grant of restricted shares to 45% of the authorized shares. The Bank believes that such awards better align the interests of its employees with those of its shareholders. Restricted stock is granted at the fair value on date of grant, and 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 five years of continuous service from the grant date and expire after ten years.

There were no equity awards granted in 2020 or 2019.

(DOLLARS IN THOUSANDS)

### NOTE 9 – STOCK-BASED COMPENSATION (CONTINUED)

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, 2019 | $ 167,752 | $ 6.24 | $ 4.99 |
| Granted | – | – | – |
| Exercised | – | – | – |
| Cancelled | – | – | – |
| Forfeited | $ (15,000) | 5.80 | – |
| Outstanding at December 31, 2020 | $ 152,752 | $ 6.28 | 4.04 |
| Options exercisable at December 31, 2020 | $ 152,752 | $ 6.28 | 4.04 |

**RESTRICTED STOCK GRANTS** – A summary of nonvested restricted stock grants activity is presented below:

| | Shares | Weighted-Average Remaining Grant-Date Fair Value |
|---|---|---|
| Nonvested at December 31, 2019 | 24,000 | $ 6.00 |
| Granted | – | – |
| Vested | (6,000) | 6.00 |
| Forfeited | – | – |
| Nonvested at December 31, 2020 | 18,000 | $ 6.28 |

At December 31, 2020, there was approximately $98 of total unrecognized compensation cost related to share-based compensation arrangements. The cost is expected to be recognized over a period of approximately three years.

### NOTE 10 – SHAREHOLDERS' EQUITY

**WARRANTS** – The Bank had 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 expired June 5, 2019.

(DOLLARS IN THOUSANDS)

## NOTE 10 – SHAREHOLDERS' EQUITY (CONTINUED)

**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 consolidated 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. During 2020, with the passage of the CARES Act, federal banking agencies passed an interim rule to assign a zero percent risk weighting to PPP loans that remained in effect as of December 31, 2020.

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 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2020 and 2019, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2020, 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 1 risk-based, Common equity Tier 1, and Tier 1 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 | |
|---|---|---|---|---|---|---|---|---|
| **As of December 31, 2020** | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total capital | | | | | | | | |
| (to risk-weighted assets) | $ 12,801 | 15.47% | $ 6,667 | 8.00% | $ 8,751 | 10.50% | $ 8,334 | 10.00% |
| Tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | 11,766 | 14.22% | 5,000 | 6.00% | 7,084 | 8.50% | 6,667 | 8.00% |
| Common equity Tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | 11,766 | 14.22% | 3,750 | 4.50% | 5,834 | 7.00% | 5,417 | 6.50% |
| Tier 1 capital | | | | | | | | |
| (to average assets) | 11,766 | 8.20% | 5,738 | 4.00% | N/A | | 7,172 | 5.00% |
| **As of December 31, 2019** | | | | | | | | |
| Total capital | | | | | | | | |
| (to risk-weighted assets) | $ 11,866 | 15.67% | $ 6,058 | 8.00% | $ 7,951 | 10.50% | $ 7,572 | 10.00% |
| Tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | 11,070 | 14.62% | 4,543 | 6.00% | 6,436 | 8.50% | 6,058 | 8.00% |
| Common equity Tier 1 capital | | | | | | | | |
| (to risk-weighted assets) | 11,070 | 14.62% | 3,407 | 4.50% | 5,300 | 7.00% | 4,922 | 6.50% |
| Tier 1 capital | | | | | | | | |
| (to average assets) | 11,070 | 9.36% | 4,733 | 4.00% | N/A | | 5,916 | 5.00% |

(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 amended rules also established a "capital conservation buffer" of 2.5% above the new regulatory minimum capital ratios, and resulted in the following phased-in minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%; (ii) a Tier 1 capital ratio of 8.5%; and (iii) total capital repurchase, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations established a maximum percentage of eligible retained income that could be utilized for such actions. The net unrealized gain or loss on available-for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2020, 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:

| | 2020 | 2019 |
|---|---|---|
| Balance, beginning of year | $ 1,515 | $ 3,252 |
| New loans | – | – |
| Repayments | (323) | (1,737) |
| Balance, end of year | $ 1,192 | $ 1,515 |

There were $3,127 and $2,066 of related party deposits at December 31, 2020 and 2019, respectively.

### NOTE 12 – 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.

(DOLLARS IN THOUSANDS)

## NOTE 12 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

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.

**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 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 2020 or 2019.

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

| | 2020 | 2019 |
|---|---|---|
| Commitments to extend credit | | |
| Real estate secured | $ 7,481 | $ 7,630 |
| Commercial real estate, construction, and land development | 3,487 | 2,964 |
| Commercial loans | 5,418 | 4,362 |
| Other | 411 | 351 |
| Total commitments to extend credit | $ 16,797 | $ 15,307 |

**CONTINGENCIES** – At periodic intervals, the state of Washington and the FDIC routinely examine the Bank's consolidated 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 consolidated financial statements be adjusted in accordance with their findings.

### NOTE 12 – COMMITMENTS AND CONTINGENCIES (CONTINUED)

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 consolidated financial statements.

On March 11, 2020, the World Health Organization assessed the COVID-19 outbreak and characterized it is a pandemic. Subsequent to the declaration of the pandemic, a variety of federal, state, and local governments have taken actions in response to the pandemic. The duration and intensity of the impact of COVID-19 and resulting impact to the Bank is unknown.

### NOTE 13 – 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, 2020 and 2019.

(DOLLARS IN THOUSANDS)

## NOTE 13 – FAIR VALUE MEASUREMENTS (CONTINUED)

### 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).

The following table presents the Bank's assets measured at fair value on a recurring basis as of December 31, 2020 and 2019.

| **2020** | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Mortgage-backed securities | $ – | $ 1,954 | $ – | $ 1,954 |
| Collateralized mortgage obligation securities | $ – | 4,384 | $ – | 4,384 |
| Total | $ – | $ 6,338 | $ – | $ 6,338 |
| **2019** | | | | |
| Mortgage-backed securities | $ – | $ 9,385 | $ – | $ 9,385 |
| Total | $ – | $ 9,385 | $ – | $ 9,385 |

**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 as of December 31, 2019. There were no assets measured at fair value on a nonrecurring basis as of December 31, 2020.

| **December 31, 2019** | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Impaired loans | $ – | $ – | $ 2,468 | $ 2,468 |

### NOTE 13 – FAIR VALUE MEASUREMENTS (CONTINUED)

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 year ending December 31, 2019 is in the below table.

| | Fair Value at December 31, 2019 | Valuation Technique | Unobservable Input | Range [1] |
|---|---|---|---|---|
| Impaired loans | $ 2,468 | Real estate appraisal | Discount to appraisal | 0% - 10% |

[1] Discount for selling costs.

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 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.

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