

# A new look to banking.

2014 FINANCIAL STATEMENT



Liberty  
Bay  
Bank

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# Dear Shareholders, Clients and Employees,

As I reflect upon the last year, I must also look to Liberty Bay Bank's remarkable history to date and toward its vibrant future.

Founded in 2009 with the vision and commitment of regional business leaders who believed a different breed of community bank was needed, Liberty Bay Bank has today achieved impressive growth built on several guiding principles: *innovation, determination, collaboration* – and I daresay, *inspiration*.

Liberty Bay Bank is, indeed, growing into the community bank we envisioned it becoming.

Vision and determined action have combined to bring us to a proud fifth year of results reporting where a number of vital achievements can be celebrated. The bank's financial performance is illustrated inside this report, and there are key milestones we also need to acknowledge.

- First-time positive annual net earnings for the bank in fiscal year 2014. Liberty Bay Bank earned \$187,000 in 2014 and was profitable for the last six consecutive quarters.
- Continued strong loan and deposit growth. Year-over-year loans increased \$8.5 million, or 18%; deposits increased \$9.0 million, or 16%. Our non-interest bearing deposits increased by \$ 4.1 million or 41%.
- Liberty Bay Bank is ranked # 1 for deposit market share in Poulsbo out of all regional and community banks, and ranked #3 in percentage loan growth in the State of Washington for banks under \$300 million in total assets.
- Excellent credit quality management, with zero past due and non-performing loans, and the vast majority of loans kept and carefully managed in-house.

The enhanced momentum, market presence, and bottom-line performance we have experienced in 2014 and particularly in the last three years are the result of our hard-working team of intelligent professional bankers and our tireless staff, who keep their promise of building relationships with each and every client.

While Liberty Bay Bank's strengths may lie in offering progressive business banking solutions, our expanding client base includes loyal and satisfied commercial ventures and individuals stretching from Gig Harbor to Port Townsend to Seattle, as well as in our immediate Kitsap county communities. The confidence and trust our communities and our clients place in Liberty Bay Bank are certainly among one of its most essential assets.

Together, with continued innovation, determination, collaboration, and inspiration, we have brought a new look to community banking. It is reflected in our financial performance, in the spirit of our brand and new marketing campaign, and in our entire team's passion to engage with, invest in, and support the very fabric of the communities we serve.

We started this journey for you. Thank you for your confidence in our vision.



**Richard Darrow**

PRESIDENT &  
CHIEF EXECUTIVE OFFICER

## BOARD OF DIRECTORS

**Eric Anderson**

Director & Founder

**Richard Darrow**

President &  
Chief Executive Officer

**James Ferris**

Director & Founder

**Marie Gallagher**

Director & Founder

**Klaus Golombek**

Director & Founder

**Clif McKenzie**

Director & Founder

**Joseph Michelsen**

Director & Founder

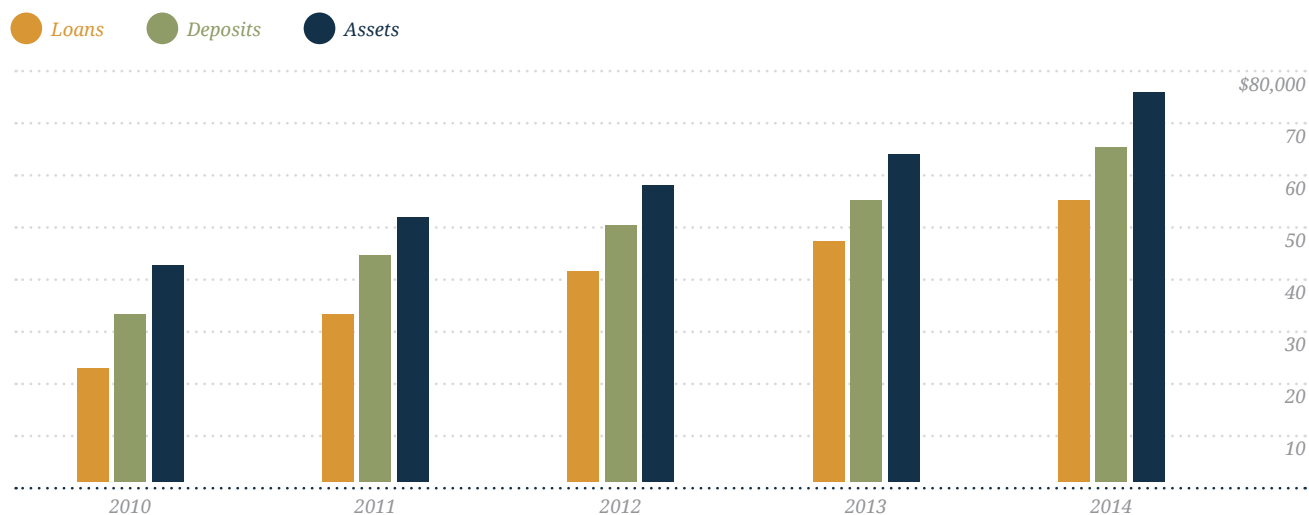
**William Parnell**

Chairman & Founder

**Jefferey Uberuaga**

Director & Founder

## FINANCIAL HIGHLIGHTS (dollars in thousands except per share amounts)



<b>At December 31</b>	2010	2011	2012	2013	2014
Assets	\$41,614	\$52,202	\$58,086	\$64,657	<b>\$76,045</b>
Loans	23,565	33,740	41,752	47,203	<b>55,718</b>
Deposits	34,127	45,188	50,085	55,910	<b>64,992</b>
Stockholders' equity	7,235	6,763	7,817	7,514	<b>7,838</b>

<b>For the year ended</b>	2010	2011	2012	2013	2014
Net interest income	\$741	\$1,757	\$2,112	\$2,333	<b>\$2,830</b>
Net income (loss)	(1,906)	(530)	(47)	(191)	<b>187</b>

<b>Key Operating Ratios</b>	2010	2011	2012	2013	2014
Return on average equity	-23.20%	-7.60%	-0.70%	-2.50%	<b>2.44%</b>
Return on average assets	-5.81%	-0.93%	-0.09%	-0.31%	<b>0.27%</b>
Net interest margin	2.59%	3.33%	4.16%	3.93%	<b>4.24%</b>
Non-interest expense to average assets	7.22%	4.74%	4.62%	4.40%	<b>4.13%</b>
Ratio of non-performing loans to total assets	-	-	-	-	-
Net loan chargeoffs to average loans	-	-	-	-	-

<b>Capital Ratios</b>	2010	2011	2012	2013	2014
Leverage	18.81%	11.98%	14.19%	11.98%	<b>10.44%</b>
Total risk-based	30.25%	22.05%	20.53%	17.22%	<b>15.12%</b>

# Report of Independent Auditors

## Report on Financial Statements

We have audited the accompanying financial statements of Liberty Bay Bank, which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income, comprehensive income (loss), 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 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, 2014 and 2013, 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 19, 2015

## BALANCE SHEETS (dollars in thousands)

	2014	2013
<b>ASSETS</b>		
CASH AND CASH EQUIVALENTS		
Cash and due from banks	\$1,156	\$1,134
Overnight funds	3,675	1,191
Total cash and cash equivalents	4,831	2,325
INTEREST-BEARING DEPOSITS WITH OTHER FINANCIAL INSTITUTIONS	86	1,614
SECURITIES AVAILABLE-FOR-SALE, at fair value	9,411	7,701
SECURITIES HELD-TO-MATURITY, at amortized cost	4,277	4,118
FEDERAL HOME LOAN BANK stock	135	28
LOANS AND LEASES	55,718	47,203
Less allowance for credit losses	660	652
Total loans and leases, net	55,058	46,551
LEASEHOLDS AND EQUIPMENT, net	499	578
ACCRUED INTEREST RECEIVABLE	202	175
OTHER REAL ESTATE OWNED, net	1,248	1,364
OTHER ASSETS	298	203
Total assets	<u>\$76,045</u>	<u>\$64,657</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
DEPOSITS		
Noninterest-bearing	\$14,326	\$10,180
Interest-bearing	50,666	45,730
Total deposits	64,992	55,910
FEDERAL HOME LOAN BANK ADVANCES	3,000	1,000
ACCRUED INTEREST PAYABLE	13	4
OTHER LIABILITIES	202	229
Total liabilities	68,207	57,143
SHAREHOLDERS' EQUITY		
Common stock, \$1 par value, 10,000,000 shares authorized, 1,411,261 shares issued and outstanding at December 31, 2014 and 2013	1,411	1,411
Additional paid-in capital	11,604	11,594
Accumulated deficit	(5,185)	(5,372)
Accumulated other comprehensive income (loss)	8	(119)
Total shareholders' equity	7,838	7,514
Total liabilities and shareholders' equity	<u>\$76,045</u>	<u>\$64,657</u>

## STATEMENTS OF INCOME (dollars in thousands)

	2014	2013
INTEREST AND FEE INCOME		
Loans and leases, including fees	\$2,863	\$2,456
Investments	207	111
Interest-bearing deposits and overnight funds	11	27
Total interest income	3,081	2,594
INTEREST EXPENSE		
Deposits	243	259
Federal Home Loan Bank advances	8	2
Total interest expense	251	261
NET INTEREST INCOME	2,830	2,333
PROVISION FOR CREDIT LOSSES	8	8
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	2,822	2,325
NONINTEREST INCOME		
Gain on sale of investment securities	43	1
Service charges on deposits	42	37
Other income	52	183
Total noninterest income	137	221
NONINTEREST EXPENSE		
Salaries and employee benefits	1,631	1,508
Occupancy and equipment	382	383
Data processing	339	356
Advertising and business development	28	36
Professional and regulatory expenses	223	222
Other expenses	269	232
Total noninterest expense	2,872	2,737
NET INCOME (LOSS) BEFORE BENEFIT FOR INCOME TAX	87	(191)
BENEFIT FOR FEDERAL INCOME TAX	100	-
NET INCOME (LOSS)	<u>\$187</u>	<u>\$(191)</u>

## STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (dollars in thousands)

	2014	2013
NET INCOME (LOSS)	\$187	\$(191)
Other comprehensive income (loss)		
Unrealized gain (loss) on securities available-for-sale		
Unrealized holding gain (loss)	170	(118)
Reclassification adjustments for realized gains on securities available-for-sale	(43)	(1)
Other comprehensive income (loss)	127	(119)
COMPREHENSIVE INCOME (LOSS)	<u>\$314</u>	<u>\$(310)</u>

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (dollars in thousands)

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
	Shares	Amount				
BALANCE, December 31, 2012	1,411,261	\$1,411	\$11,587	\$(5,181)	\$-	\$7,817
Net loss	-	-	-	(191)	-	(191)
Other comprehensive loss	-	-	-	-	(119)	(119)
Stock-based compensation	-	-	7	-	-	7
BALANCE, December 31, 2013	1,411,261	1,411	11,594	(5,372)	(119)	7,514
Net income	-	-	-	187	-	187
Other comprehensive gain	-	-	-	-	127	127
Stock-based compensation	-	-	10	-	-	10
BALANCE, December 31, 2014	<u>1,411,261</u>	<u>\$1,411</u>	<u>\$11,604</u>	<u>\$(5,185)</u>	<u>\$8</u>	<u>\$7,838</u>



## STATEMENTS OF CASH FLOWS (dollars in thousands)

	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$187	\$(191)
Adjustments to reconcile net income (loss) to net cash from operating activities		
Provision for credit losses	8	8
Depreciation and amortization	111	112
Net amortization of investment security premium/discount	83	42
Stock-based compensation	10	7
Net gain on sale of investment securities	(43)	(1)
Changes in operating assets and liabilities		
Accrued interest receivable	(27)	(57)
Deferred provision for income taxes	(100)	-
Other assets	5	86
Accrued interest payable	9	2
Other liabilities	(27)	47
Net cash provided by operating activities	216	55
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net change in interest-bearing deposits with other financial institutions	1,528	2,009
Activity in securities available-for-sale		
Maturities, prepayments, and calls	735	263
Purchases	(6,542)	(9,608)
Sales	4,213	1,504
Activity in securities held-to-maturity		
Maturities, prepayments, and calls	310	162
Purchases	(498)	(4,300)
Purchase of FHLB stock	(107)	-
Partial sale of other real estate owned	116	-
Loan and lease originations, net of principal collections	(8,515)	(6,815)
Purchase of premises and equipment, net	(32)	(10)
Net cash used in investing activities	(8,792)	(16,795)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	9,082	5,825
Net proceeds from Federal Home Loan Bank advances	2,000	1,000
Net cash received from financing activities	11,082	6,825
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	<b>2,506</b>	<b>(9,915)</b>
CASH AND CASH EQUIVALENTS, beginning of year	2,325	12,240
CASH AND CASH EQUIVALENTS, end of year	\$4,831	\$2,325
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>		
Cash paid during the year for interest	\$242	\$259
<b>NONCASH INVESTING AND FINANCING ACTIVITIES</b>		
Unrealized gain (loss) on securities available-for-sale	\$127	\$(119)
Loans transferred to other real estate owned	\$-	\$1,364

## NOTES TO FINANCIAL STATEMENTS (dollars in thousands)

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

**Nature of operations** - A Notice of Intention to Organize a State Bank was filed by Liberty Bay Bank (the Bank) with the State of Washington Department of Financial Institutions (the DFI). In September 2007, an Application for a Bank Charter and Federal Deposit Insurance was filed with the DFI and the Federal Deposit Insurance Corporation (FDIC), and was accepted in December 2007. From the filing date until June 11, 2009, the organizers of the Bank completed the various steps to organize the Bank, acquired capital in the amount of \$11,500, and prepared the Bank to commence operations.

The Bank provides a full range of banking services to individual and corporate customers through its sole office in Poulsbo, Washington. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial loans, commercial real estate loans, and leases. 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, valuation of other real estate owned, and deferred tax assets. All dollar amounts are stated in thousands.

**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 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.

**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, 2014 or 2013.

**Investment securities** - Investment securities are classified into one of three categories: (1) held-to-maturity, (2) available-for-sale, or (3) trading. Investment securities are categorized as held-to-maturity when the Bank has the positive intent and ability to hold those securities to maturity. The Bank held no trading securities at December 31, 2014 and 2013, respectively.

Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Investment securities categorized as available-for-sale are generally held for investment purposes (to maturity), although unanticipated future events may result in the sale of some securities. Available-for-sale securities are recorded at estimated fair value, with the net unrealized gain or loss reported as "other comprehensive gain (loss)" within the statements of changes in shareholders' equity. Realized gains or losses on dispositions are based on the net proceeds and the adjusted carrying amount of securities sold, 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 (FHLB) stock** - The Bank's investment in Federal Home Loan Bank of Seattle stock is carried at par value (\$100 per share), which reasonably approximates its fair value. 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 may request redemption at par value of any stock in excess of the amount the Bank is required to hold. Stock redemptions are at the discretion of the FHLB.

At December 31, 2014 and 2013, the Bank owned 1,350 and 281 shares of FHLB stock, respectively. FHLB stock is carried at par and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par.

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 determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared with the capital stock amount for the FHLB and the length of time this situation has persisted; (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB; and (4) the liquidity position of the FHLB. Based on the above, the Bank has determined that there is not an other-than-temporary impairment on the FHLB stock investment as of December 31, 2014 or 2013.

**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, 2014 or 2013.

**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.

**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 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. 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.

**Leaseholds and equipment** - Bank leaseholds and equipment are stated at cost and depreciated or amortized using the straight-line method over the estimated useful lives of the related assets, which range from 3 to 12 years. Total depreciation and amortization expense was \$111 and \$112 for the years ended December 31, 2014 and 2013, respectively.

**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. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs incurred in maintaining foreclosed property and subsequent adjustments to the carrying amount of the property are included in noninterest expense. The Bank held \$1,248 and \$1,364 of foreclosed assets at December 31, 2014 and 2013, respectively.

**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 \$6 and \$18 in 2014 and 2013, respectively.

**Comprehensive income (loss)** - 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, 2014 and 2013, are included within the statements of comprehensive income (loss).

**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.

**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 19, 2015, the date the financial statements were issued, and noted no subsequent events requiring accrual or disclosure.

## Note 2 - Investments

The amortized cost and fair value of securities, with gross unrealized gain and losses, at December 31 follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2014</b>				
Securities available-for-sale				
Obligations of U.S. government agencies	\$3,019	\$3	\$(8)	\$3,014
Mortgage-backed securities	6,384	35	(22)	6,397
Total available-for-sale	<u>\$9,403</u>	<u>\$38</u>	<u>\$(30)</u>	<u>\$9,411</u>
Held-to-maturity				
Mortgage-backed securities	<u>\$4,277</u>	<u>\$3</u>	<u>\$(83)</u>	<u>\$4,197</u>
<b>December 31, 2013</b>				
Securities available-for-sale				
Obligations of U.S. government agencies	\$2,497	\$6	\$(20)	\$2,483
Mortgage-backed securities	5,323	11	(116)	5,218
Total available-for-sale	<u>\$7,820</u>	<u>\$17</u>	<u>\$(136)</u>	<u>\$7,701</u>
Held-to-maturity				
Mortgage-backed securities	<u>\$4,118</u>	<u>\$-</u>	<u>\$(313)</u>	<u>\$3,805</u>

The amortized cost and estimated fair value of investment securities at December 31, 2014, 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	\$3,019	\$3,014	\$-	\$-
Due in 5 to 15 years	6,384	6,397	-	-
Due after 15 years	-	-	4,277	4,197
	<u>\$9,403</u>	<u>\$9,411</u>	<u>\$4,277</u>	<u>\$4,197</u>

As of December 31, 2014, there were 2 securities with a carrying value of \$1,991 pledged to secure borrowings at the FHLB and 8 securities with a carrying value of \$5,818 pledged to secure public deposits. As of December 31, 2013, there were 8 securities with a carrying value of \$5,060 pledged to secure borrowings at the FHLB and 9 securities with a carrying value of \$6,759 pledged to secure public deposits.

During the year ended December 31, 2014, the Bank sold \$4,213 in investment securities, realizing gross gains of \$43 and no losses. During the year ended December 31, 2013, the Bank sold \$1,504 in investment securities, realizing gross gains of \$1 and no losses.

At December 31, 2014 and 2013, 9 and 10 securities, respectively, were in an unrealized loss position. 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 will not be 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		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
December 31, 2014					
Securities available-for-sale					
Obligations of U.S. government agencies	\$-	\$-	\$8	\$1,001	\$8
Mortgage-backed securities	-	-	22	1,708	22
	<u>\$-</u>	<u>\$-</u>	<u>\$30</u>	<u>\$2,709</u>	<u>\$30</u>
Held-to-maturity					
Mortgage-backed securities	<u>\$-</u>	<u>\$-</u>	<u>\$83</u>	<u>\$3,706</u>	<u>\$83</u>
December 31, 2013					
Securities available-for-sale					
Obligations of U.S. government agencies	\$20	\$1,492	\$-	\$-	\$20
Mortgage-backed securities	116	2,806	-	-	116
	<u>\$136</u>	<u>\$4,298</u>	<u>\$-</u>	<u>\$-</u>	<u>\$136</u>
Held-to-maturity					
Mortgage-backed securities	<u>\$313</u>	<u>\$3,805</u>	<u>\$-</u>	<u>\$-</u>	<u>\$313</u>

### Note 3 - Loans, Leases, and Allowance for Credit Losses

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

	2014	2013
Commercial real estate	\$30,305	\$25,721
Commercial	8,144	7,964
Construction and land	6,130	3,724
Consumer	530	424
Residential real estate	10,223	7,926
Leases	612	1,585
Gross loans and leases	55,944	47,344
Deferred fees and costs	(226)	(141)
Allowance for credit losses	(660)	(652)
Total loans and leases, net	<u>\$55,058</u>	<u>\$46,551</u>

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

	2014	2013
Minimum lease payments receivable	\$628	\$1,659
Estimated unguaranteed residual values of leased property	8	13
Unearned income	(24)	(87)
	<u>\$612</u>	<u>\$1,585</u>

At December 31, future minimum lease payments to be received are as follows:

2015	\$470
2016	146
2017	12
	<u>\$628</u>



The following table presents the activity in the allowance for credit losses by segment for the years ended December 31, 2014 and 2013:

	Beginning Balance	Provision (Recovery) for Credit Losses	Charge-offs	Recoveries	Ending Ending Balance
<b>2014</b>					
Commercial real estate	\$253	\$4	\$-	\$-	\$257
Commercial	65	(5)	-	-	60
Construction and land	57	67	-	-	124
Consumer	3	-	-	-	3
Residential real estate	76	-	-	-	76
Leases	21	(15)	-	-	6
Unallocated	177	(43)	-	-	134
	<u>\$652</u>	<u>\$8</u>	<u>\$-</u>	<u>\$-</u>	<u>\$660</u>
<b>2013</b>					
Commercial real estate	\$230	\$23	\$-	\$-	\$253
Commercial	58	7	-	-	65
Construction and land	74	(17)	-	-	57
Consumer	6	(3)	-	-	3
Residential real estate	29	47	-	-	76
Leases	33	(12)	-	-	21
Unallocated	214	(37)	-	-	177
	<u>\$644</u>	<u>\$8</u>	<u>\$-</u>	<u>\$-</u>	<u>\$652</u>

A loan is considered impaired when the Bank has determined that it may be unable to collect payments of principal or interest when due under the terms of the loan. In the process of identifying loans as impaired, management takes into consideration factors that include payment history and status, collateral value, financial condition of the borrower, and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered by management on a case-by-case basis, after taking into consideration the totality of circumstances surrounding the loans and the borrowers, including payment history and amounts of any payment shortfall, length and reason for delay, and likelihood of return to stable performance. 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.

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2014 and 2013:

	Recorded Investments (Loan Balance Less Charge- off)	Unpaid Principal Balance	Related Allowance	Average Investment in Impaired Loans	Interest Income Recognized
<b>2014</b>					
With no allowance recorded					
Commercial real estate	\$1,226	\$1,226	\$-	\$1,229	\$16
Total					
Commercial real estate	\$1,226	\$1,226	\$-	\$1,229	\$16
	<u>\$1,226</u>	<u>\$1,226</u>	<u>\$-</u>	<u>\$1,229</u>	<u>\$16</u>
<b>2013</b>					
With no allowance recorded					
Commercial real estate	\$-	\$-	\$-	\$682	\$-
Residential real estate	-	-	-	77	4
Total					
Commercial real estate	\$-	\$-	\$-	\$682	\$-
Residential real estate	-	-	-	77	4
	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$759</u>	<u>\$4</u>

The average investment in impaired loans represents impaired loan balances as a function of the percentage of time while impaired during the periods ended December 31, 2014 and 2013.

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2014 and 2013:

	Allowance for Credit Losses			Loans and Leases		
		Ending Balance	Ending Balance		Ending Balance	Ending Balance
	Ending Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Ending Balance	Individually Evaluated for Impairment	Collectively Evaluated for Impairment
<b>2014</b>						
Commercial real estate	\$257	\$-	\$257	\$30,305	\$1,226	\$29,079
Commercial	60	-	60	8,144	-	8,144
Construction and land	124	-	124	6,130	-	6,130
Consumer	3	-	3	530	-	530
Residential real estate	76	-	76	10,223	-	10,223
Leases	6	-	6	612	-	612
Unallocated	134	-	134	-	-	-
	<u>\$660</u>	<u>\$-</u>	<u>\$660</u>	<u>\$55,944</u>	<u>\$1,226</u>	<u>\$54,718</u>
<b>2013</b>						
Commercial real estate	\$253	\$-	\$253	\$25,721	\$-	\$25,721
Commercial	65	-	65	7,964	-	7,964
Construction and land	57	-	57	3,724	-	3,724
Consumer	3	-	3	424	-	424
Residential real estate	76	-	76	7,926	-	7,926
Leases	21	-	21	1,585	-	1,585
Unallocated	177	-	177	-	-	-
	<u>\$652</u>	<u>\$-</u>	<u>\$652</u>	<u>\$47,344</u>	<u>\$-</u>	<u>\$47,344</u>

The Bank pledged certain commercial loans as collateral for purposes of borrowings with the FHLB. Loans totaling \$11,516 were pledged to the FHLB at December 31, 2014 (Note 6).

**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.

The following table presents current and past due loans, net of partial loan charge-offs, by type and delinquency status, as of December 31, 2014 and 2013:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans
<b>2014</b>						
Commercial real estate	\$-	\$-	\$-	\$-	\$30,305	\$30,305
Commercial	-	-	-	-	8,144	8,144
Construction and land	-	-	-	-	6,130	6,130
Consumer	-	-	-	-	530	530
Residential real estate	-	-	-	-	10,223	10,223
Leases	-	-	-	-	612	612
	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$55,944</u>	<u>\$55,944</u>
<b>2013</b>						
Commercial real estate	\$-	\$-	\$-	\$-	\$25,721	\$25,721
Commercial	-	-	-	-	7,964	7,964
Construction and land	-	-	-	-	3,724	3,724
Consumer	-	-	-	-	424	424
Residential real estate	-	-	-	-	7,926	7,926
Leases	11	-	-	11	1,574	1,585
	<u>\$11</u>	<u>\$-</u>	<u>\$-</u>	<u>\$11</u>	<u>\$47,333</u>	<u>\$47,344</u>

**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, 2014, the Bank had no loans classified as doubtful or 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.

The following tables represent the credit risk profile by internally assigned grade and performing status as of December 31, 2014 and 2013, by class of loans:

<b>Credit Risk Profile by Internally Assigned Grade</b>							
<b>2014</b>	Commercial Real Estate	Commercial	Construction and Land	Consumer	Residential Real Estate	Leases	Total
Grade							
Pass	\$27,972	\$6,437	\$4,984	\$530	\$9,770	\$612	\$50,305
Watch	1,107	1,707	1,013	-	453	-	4,280
Special mention	-	-	99	-	-	-	99
Substandard	1,226	-	34	-	-	-	1,260
	<u>\$30,305</u>	<u>\$8,144</u>	<u>\$6,130</u>	<u>\$530</u>	<u>\$10,223</u>	<u>\$612</u>	<u>\$55,944</u>
<b>2013</b>							
Grade							
Pass	\$24,819	\$6,212	\$3,724	\$424	\$7,165	\$1,558	\$43,902
Watch	732	1,707	-	-	661	17	3,117
Special mention	170	45	-	-	100	10	325
Substandard	-	-	-	-	-	-	-
	<u>\$25,721</u>	<u>\$7,964</u>	<u>\$3,724</u>	<u>\$424</u>	<u>\$7,926</u>	<u>\$1,585</u>	<u>\$47,344</u>
<b>Credit Risk Profile Based on Payment Activity</b>							
<b>2014</b>	Commercial Real Estate	Commercial	Construction and Land	Consumer	Residential Real Estate	Leases	Total
Performing	\$30,305	\$8,144	\$6,130	\$530	\$10,223	\$612	\$55,944
Nonperforming	-	-	-	-	-	-	-
	<u>\$30,305</u>	<u>\$8,144</u>	<u>\$6,130</u>	<u>\$530</u>	<u>\$10,223</u>	<u>\$612</u>	<u>\$55,944</u>
<b>2013</b>							
Performing	\$25,721	\$7,964	\$3,724	\$424	\$7,926	\$1,585	\$47,344
Nonperforming	-	-	-	-	-	-	-
	<u>\$25,721</u>	<u>\$7,964</u>	<u>\$3,724</u>	<u>\$424</u>	<u>\$7,926</u>	<u>\$1,585</u>	<u>\$47,344</u>

There were no nonaccrual loans at December 31, 2014 or 2013. There were no loans 90 days or more past due and still accruing at December 31, 2014 or 2013.

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, 2014 and 2013, or modified during the years then ended.

## Note 4 - Leaseholds and Equipment

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

	2014	2013
Leasehold improvements	\$707	\$707
Furniture, fixtures, and office equipment	350	341
Vehicles	22	10
	1,079	1,058
Less accumulated depreciation and amortization	(580)	(480)
	<u>\$499</u>	<u>\$578</u>

## Note 5 - Deposits

Deposits as of December 31 consisted of the following:

	2014	2013
Savings accounts	\$6,561	\$8,240
Certificates of deposit	22,638	14,516
Demand accounts		
Noninterest-bearing	14,326	10,180
Interest-bearing	3,655	2,608
Money market accounts	17,812	20,366
	<u>\$64,992</u>	<u>\$55,910</u>

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

2015	\$19,212
2016	3,359
2017	67
	<u>\$22,638</u>

The Bank had \$8,239 and \$8,212 of certificates of deposit that met or exceeded the \$250,000 federally insured limit at December 31, 2014 and 2013, respectively.

## Note 6 - Credit Arrangements

At December 31, 2014, committed line-of-credit agreements totaling approximately \$5.0 million were available to the Bank from unaffiliated banks. 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 \$550 maintained in a demand deposit account. The compensating balances are included in cash and cash equivalents at December 31, 2014.

The Bank is a member of the Federal Home Loan Bank of Seattle, and as such, is eligible for a credit line up to 15% of total assets, subject to certain collateral requirements. At December 31, 2014, loans and investments pledged as collateral to the FHLB equated to a borrowing capacity of \$11,231. 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, 2014, the Bank had \$3,000 of borrowings outstanding with the FHLB, with a weighted-average rate of 1.03% under this agreement and maturing in 2016 and 2017. Current borrowings are collateralized by pledged investment securities (Note 2) and loans (Note 3). The excess balance of securities can be used for additional borrowings.

## Note 7 - Income Taxes

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

	2014	2015
Current	\$-	\$-
Deferred	-	-
Change in valuation allowance	(100)	-
Total tax benefit	<u>\$(100)</u>	<u>\$-</u>

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

	2014		2013	
	Amount	Percent of Pre-Tax Income	Amount	Percent of Pre-Tax Income
Income tax at statutory rates	\$30	34.00	\$(65)	34.00
Increase (decrease) resulting from				
Permanent differences	3	5.00	3	(1.00)
Valuation allowance reversal	(133)	(154.00)	62	(33.00)
Total income tax benefit	<u>\$(100)</u>	<u>(115.00)</u>	<u>\$-</u>	<u>-</u>

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

	2014	2013
Deferred tax assets		
Net operating loss carryforward	\$1,273	\$1,234
Organization expenditures	290	321
Property and equipment depreciation	28	-
Other, net	60	19
Allowance for credit losses	199	197
Subtotal	1,850	1,771
Deferred tax liabilities		
Unrealized loss on securities	3	(40)
Cash basis method of accounting	64	29
Deferred costs	126	49
Subtotal	193	38
Net deferred tax asset	1,657	1,733
Less valuation allowance on net deferred tax asset	(1,557)	(1,733)
Total	<u>\$100</u>	<u>\$-</u>

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 improving asset quality, the Bank determined that \$100 of the valuation allowance could be supported at December 31, 2014.

At December 31, 2014, the Bank has, for tax reporting purposes, a net operating loss carryforward totaling approximately \$3,743, eligible to offset future federal income taxes. The net operating loss carryforward will begin to expire in 2029.

At December 31, 2014, the Bank had unamortized preopening expenditures of approximately \$854 (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 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, 2014 or 2013.

The Bank's policy is to recognize interest and penalties in tax expense. During the years ended December 31, 2014 and 2013, the Bank recognized no interest or penalties.

The Bank files income tax returns in the U.S. federal jurisdiction. In general, the Bank is subject to U.S. federal income tax examinations by tax authorities for the years ended after 2010.



## 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. There were no Bank contributions for the years ended December 31, 2014 or 2013.

## 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 91,780 remaining shares in the Plan available to grant at December 31, 2014. 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.

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton valuation model that uses the assumptions noted in the following table. Because the Black-Scholes-Merton 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 granted is derived from the output of the option valuation model and represents the period of time that options granted are expected to be outstanding; the range given below results from certain groups of employees exhibiting different behavior. 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 during 2013 are as follows:

	2013
Weighted-average risk-free interest rate	1.93%
Dividend yield rate	0.00%
Expected volatility	10.00%
Expected term (in years)	7

There were no options granted in 2014.

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, 2013	143,970	\$6.25	8.8
Forfeited	(750)	5.50	-
Outstanding at December 31, 2014	143,220	\$6.25	7.8
Options exercisable at December 31, 2014	47,844	\$7.76	6.5

At December 31, 2014, there was approximately \$68 of total unrecognized compensation cost related to share-based compensation arrangements. The cost is expected to be recognized over a period of approximately 4.5 years.

### Note 10 - Shareholders' Equity

**Warrants** - At December 31, 2014 and 2013, 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 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, 2014 and 2013, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2014, 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, 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		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of December 31, 2014</b>						
Total capital						
(to risk-weighted assets)	\$8,499	15.12%	\$4,497 ≥	8.0%	\$5,621 ≥	10.0%
Tier I capital						
(to risk-weighted assets)	\$7,831	13.93%	\$2,249 ≥	4.0%	\$3,373 ≥	6.0%
Tier I capital						
(to average assets)	\$7,831	10.44%	\$3,001 ≥	4.0%	\$3,752 ≥	5.0%
<b>As of December 31, 2013</b>						
Total capital						
(to risk-weighted assets)	\$8,231	17.22%	\$3,824 ≥	8.0%	\$4,780 ≥	10.0%
Tier I capital						
(to risk-weighted assets)	\$7,633	15.97%	\$1,912 ≥	4.0%	\$2,868 ≥	6.0%
Tier I capital						
(to average assets)	\$7,633	11.98%	\$2,548 ≥	4.0%	\$3,185 ≥	5.0%

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 Federal Reserve and the Federal Deposit Insurance Corporation approved final capital rules in July 2013, which substantially amend the existing capital rules for banks. These new rules reflect, in part, certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010 (which standards are commonly referred to as “Basel III”) as well as requirements contemplated by the Dodd-Frank Act.

Under the new capital rules, the Bank will be required to meet certain minimum capital requirements that differ from current capital requirements. The rules implement a new capital ratio of common equity Tier 1 capital to risk-weighted assets. Common equity Tier 1 capital generally consists of retained earnings and common stock (subject to certain adjustments) as well as accumulated other comprehensive income (AOCI), except to the extent that the Bank exercises a one-time irrevocable option to exclude certain components of AOCI as of March 31, 2015. The Bank will also be required to establish a “conservation buffer,” consisting of a common equity Tier 1 capital amount equal to 2.5% of risk-weighted assets to be phased in by 2019. An institution that does not meet the conservation buffer will be subject to restrictions on certain activities including payment of dividends, stock repurchases, and discretionary bonuses to executive officers.

The prompt corrective action rules are modified to include the common equity Tier 1 capital ratio and to increase the Tier 1 capital ratio requirements for the various thresholds. For example, the requirements for the Bank to be considered well-capitalized under the rules will be a 5.0% leverage ratio, a 6.5% common equity Tier 1 capital ratio, an 8.0% Tier 1 capital ratio, and a 10.0% total capital ratio. To be adequately capitalized, those ratios are 4.0%, 4.5%, 6.0%, and 8.0%, respectively.

The rules modify the manner in which certain capital elements are determined. The rules make changes to the methods of calculating the risk-weighting of certain assets, which in turn affects the calculation of the risk-weighted capital ratios. Higher risk weights are assigned to various categories of assets, including commercial real estate loans; credit facilities that finance the

acquisition, development, or construction of real property; certain exposures or credit that are 90 days past due or are nonaccrual; securitization exposures; and, in certain cases, mortgage servicing rights and deferred tax assets.

The Bank is required to comply with the new capital rules on January 1, 2015, with a measurement date of March 31, 2015. The conservation buffer will be phased in beginning in 2016, and will take full effect on January 1, 2019. Certain calculations under the rules will also have phase-in periods.

## Note 11 - Lease Commitments

**Operating lease commitments** - The Bank leases office premises for its operations. This lease expires in 2015. The Bank has an option to renew the lease for two additional three-year terms. 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:

2015	\$264
2016	277
2017	291
2018	306
2019	321
Thereafter	480
	<u>\$1,939</u>

Rental expense, including operating expenses charged to operations, was \$242 and \$243 for the years ended December 31, 2014 and 2013, respectively.

## Note 12 - 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:

	2014	2013
Balance, beginning of year	\$3,011	\$1,443
New loans	383	1,649
Repayments	(137)	(81)
Balance, end of year	<u>\$3,257</u>	<u>\$3,011</u>

There were \$5,837 and \$5,473 of related party deposits at December 31, 2014 and 2013, respectively.

### **Note 13 - 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. The Bank also has purchased leases, which are primarily collateralized by business equipment. Although the Bank has a diversified loan and lease 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, or \$1.7 million, to any single borrower or group of related borrowers.

### **Note 14 - 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.

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 50% 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 2014 or 2013.

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

	2014	2013
Commitments to extend credit		
Real estate secured	\$1,688	\$1,061
Commercial real estate, construction, and land development	7,947	2,175
Other	3,872	2,763
Total commitments to extend credit	<u>\$13,507</u>	<u>\$5,999</u>
Financial standby letters of credit	<u>\$-</u>	<u>\$177</u>

**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 15 - Fair Value of Financial Instruments

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.

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820 establishes 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.

## 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 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
<b>2014</b>				
Obligations of U.S. government agencies	\$-	\$3,014	\$-	\$3,014
Mortgage-backed securities	-	6,397	-	6,397
<b>2013</b>				
Obligations of U.S. government agencies	\$-	\$2,483	\$-	\$2,483
Mortgage-backed securities	-	5,218	-	5,218

There were no transfers between levels during the years ended December 31, 2014 or 2013.

At December 31, 2014 and 2013, the Bank had \$1,248 and \$1,364 of other real estate recorded at fair value during the periods, respectively. Fair value was determined using market comparable data with discounts applied to appraisals 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 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.

Building Relationships That  
Strengthen Our Community™



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*Headquartered in Poulsbo and serving clients and communities throughout Puget Sound.*

