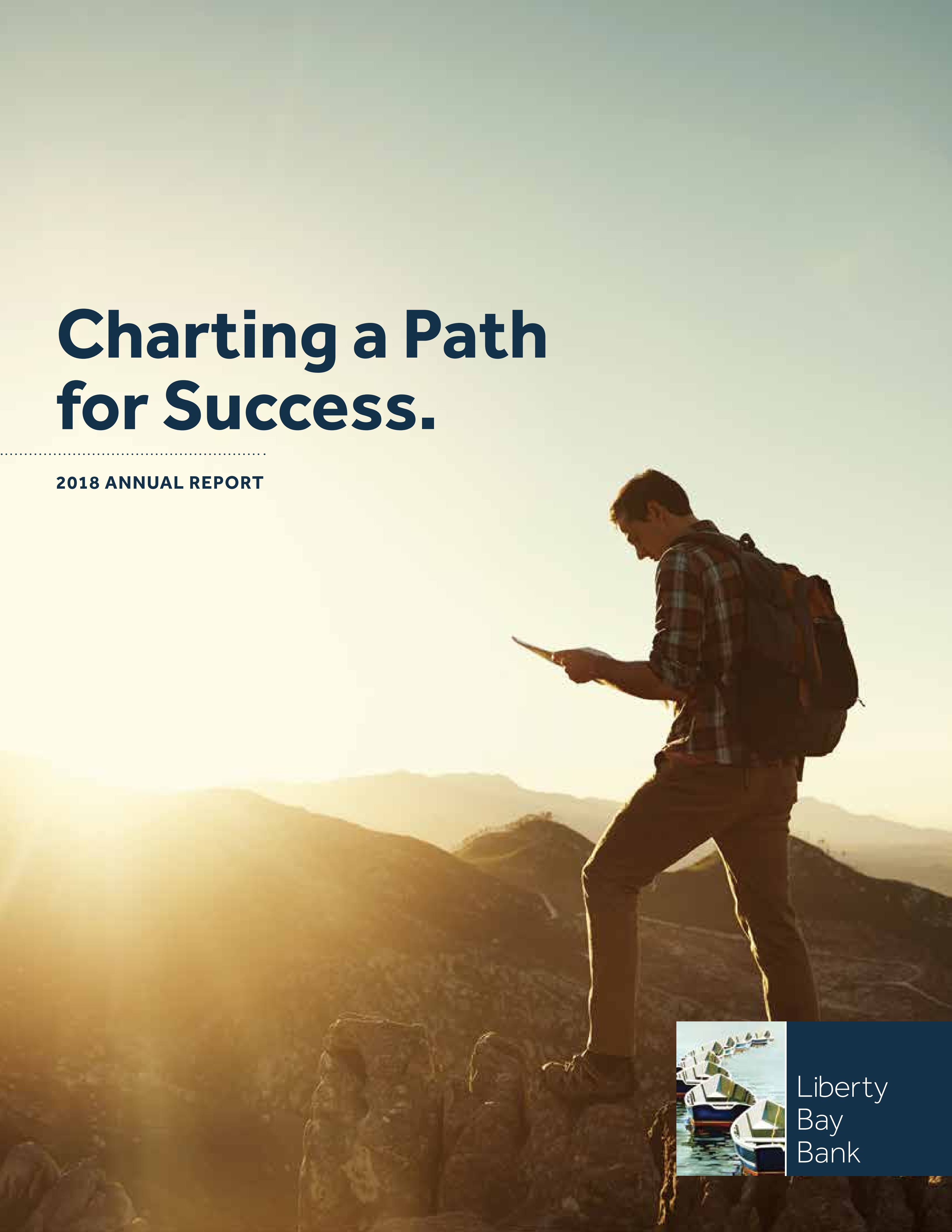
Charting a Path for Success.

2018 ANNUAL REPORT



Liberty Bay Bank

TABLE OF CONTENTS

Letter from the CEO	1
Financial Highlights	4
Report of Independent Auditors	5
Balance sheets	6
Statements of income	7
Statements of comprehensive income	8
Statements of changes in shareholders’ equity	8
Statements of cash flows	9
Notes to financial statements	10–28

Richard Darrow
PRESIDENT &
CHIEF EXECUTIVE OFFICER

Dear Shareholders, Clients and Employees,

I am pleased to report that Liberty Bay Bank had a record year. We reached an all time high for total assets at a calendar year end of $115.5 million. We also recorded our highest pre-tax net income in the bank's history of $679,000.

More importantly we continue to play a role in the communities where we live and do business. This year our employees volunteered at dozens of non-profits, schools and community organizations. Our employees are coaches, board members, financial experts and servers for so many teams, organizations and at several charity events.

We are inspired by the growth of Poulsbo and Kitsap County and the feeling we get when we see our clients on the waterfront, at the ballfield or in the grocery store. We are also excited about the future of Liberty Bay Bank. Recently, we said goodbye to two of our most loyal employees, Kristi and Duane. Both of them retired from the bank (against our protests!) and both of them continue to be clients and more importantly, friends. We promoted several employees during the past several months and we hired a number of experienced bankers who are contributing to the present and the future.

We remain focused on offering enhanced banking solutions, expanding our client base and our influence. This includes banking individuals and commercial ventures 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 the reason we show up to serve them every day.

Innovation, determination, collaboration, and inspiration continue to be our core principals. These principals are reflected in our financial performance, in the spirit of our brand and in our entire team's passion to create additional shareholder value through earnings and their commitment to the communities we serve.

As always,

Rick Darrow

Rick Darrow
President/CEO
Liberty Bay Bank

BOARD OF DIRECTORS

Eric Anderson
Director & Founder

Richard Darrow
President &
Chief Executive Officer

James Ferris
Director & Founder

Clif McKenzie
Director & Founder

Joseph Michelsen
Director & Founder

William Parnell
Chairman & Founder

Ronald Roark
Director

Jefferey Uberuaga
Director & Founder

Building Relationships That Strengthen Our Community.

Community Highlights

Kitsap Community Foundation

Liberty Bay Bank is a proud supporter of The Kitsap Community Foundation, a philanthropy services organization that connects people to the causes they care about. The 2018 Kitsap Celebration of Philanthropy event was held at the Kitsap Conference Center. Liberty Bay Bank CEO & President Rick Darrow presented the Spirit of Philanthropy award that recognizes an individual, couple, or family's commitment to philanthropy in Kitsap County. Last year the Spirit of Philanthropy award went to Tim & Bev Ryan.

Kathleen Sutton Auction Gala

Each year, LBB staff members come together to volunteer at the annual Kathleen Sutton Fund auction held at the Vista Pavilion in Port Gamble. The Kathleen Sutton Fund supports women who live in Kitsap, Jefferson, Clallam, and Mason counties and are undergoing cancer treatment. Because transportation costs are not covered by insurance, the Kathleen Sutton Fund helps alleviate the financial burden of getting to and from appointments by paying for gas, ferry fees, parking, bridge tolls, and other transit tolls.

Coffee Oasis Gala

Liberty Bay Bank is a proud sponsor of the Hope Gala, Coffee Oasis' annual fundraiser to end youth homelessness. Last year, the fundraiser was held at the Kitsap Golf and Country Club. Liberty Bay Bank President and CEO, Rick Darrow, his wife Janna, and LBB Loan Officer Tony Fyrqvist and his wife Lisa were in attendance. The Hope Gala featured a silent auction as well as a paddle raise for general support. The evening also included a case study presentation and discussion led by the Coffee Oasis founder Dave Frederick. Coffee Oasis is a local non-profit organization that offers youth programs including youth centers, street and school outreach, job training, and crisis intervention.

Poulsbo Rotary

Liberty Bay Bank is proud to have a number of staff members involved with Poulsbo Rotary events each year. Kristi Sutton, Relationship Associate, and Tony Fyrqvist, VP & Relationship Manager, were both in attendance at Poulsbo-North Kitsap Rotary Club's Halloween-themed gala and auction. The event raised $97,924 to support a variety of community organizations including North Kitsap schools, Poulsbo Historical Society, City of Poulsbo Parks and Recreation programs, Maritime Museum, and Fish Park.

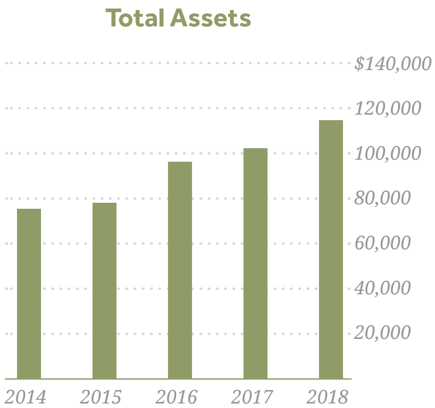
North Kitsap Fishline

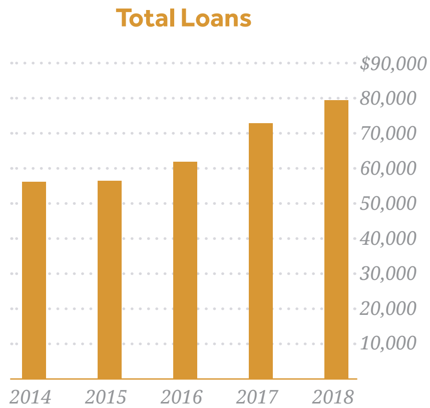
Each year, Liberty Bay Bank customers and employees collect and donate food and supplies for North Kitsap Fishline. A staple in our community since 1967, North Kitsap Fishline goes beyond food, offering other services to our neighbors including housing and utility assistance. To continue to support our local food bank, we provide a collection barrel located in our lobby for non-perishable food items and hygiene items. In the autumn, we ran a school supply drive for children in need. Donations included everything from pens and pencils to notebooks, scissors, and crayons. This collection went to support North Kitsap Fishline's School Supply program; a program that ensures children, from Kindergarten to 12th grade, are getting the supplies they need for the school year.

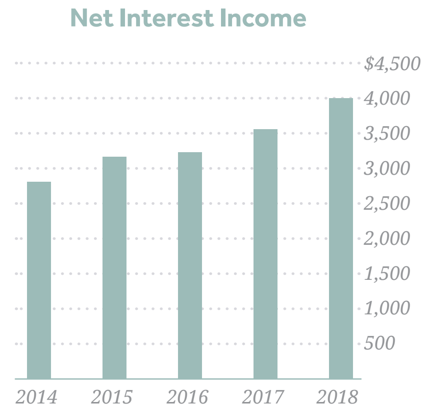
Jewel Box Gala

Liberty Bay Bank's Jeremy Key, Denise Nicolet, Danielle Hampton, and Jennifer Carrier volunteered at the 10th annual Gems of the Jewel Box Gala Fundraiser where they ran the registration table and supported the raffles and live auction. The evening raised over $46,000. All funds raised at the event go toward the purchase of much-needed sound system equipment and to purchase rights for their productions. The Jewel Box Theatre is Poulsbo's own community theater run entirely by volunteers.

FINANCIAL HIGHLIGHTS (dollars in thousands except per share amounts)







At December 31	2014	2015	2016	2017	**2018**
Assets	$76,045	$78,553	$96,840	$103,310	**$115,478**
Loans	55,718	56,026	61,562	72,311	**78,980**
Deposits	64,992	59,788	68,205	78,743	**92,400**
Stockholders' equity	7,838	8,558	9,423	9,289	**9,774**

For the year ended	2014	2015	2016	2017	**2018**
Net interest income	$2,830	$3,182	$3,243	$3,569	**$4,023**
Pre-tax income	$87	$202	$398	$424	**$679**
Net income (loss)	187	702	1,228	(294)	**527**
Noninterest income	137	126	267	112	**255**
Noninterest expenses	2,872	3,051	3,082	3,245	**3,560**

Key Operating Ratios	2014	2015	2016	2017	**2018**
Return on average equity (pre-tax income)	1.14%	2.55%	4.88%	5.13%	**7.27%**
Return on average equity (net income)	2.44%	8.74%	13.69%	-3.03%	**5.64%**
Return on average assets (pre-tax income)	0.13%	0.26%	0.46%	0.44%	**0.61%**
Return on average assets (net income)	0.27%	0.91%	1.39%	-0.30%	**0.48%**
Net interest margin	4.24%	4.30%	3.89%	3.85%	**3.84%**
Non-interest expense to average assets	4.13%	3.93%	3.50%	3.29%	**3.22%**
Ratio of non-performing loans to total assets	-	-	0.01%	0.01%	**0.58%**
Net loan chargeoffs to average loans	-	-	-	0.01%	**0.00%**

Regulatory Capital Ratios	2014	2015	2016	2017	**2018**
Tier 1 Leverage	10.44%	10.59%	9.44%	9.21%	**8.55%**
Total risk-based	15.12%	14.74%	14.36%	13.96%	**13.66%**

Report of Independent Auditors

To the Board of Directors and Shareholders
Liberty Bay Bank

Report on the Financial Statements

We have audited the accompanying financial statements of Liberty Bay Bank, which comprise the balance sheets as of December 31, 2018 and 2017, 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Liberty Bay Bank as of December 31, 2018 and 2017, 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 21, 2019

BALANCE SHEETS (dollars in thousands)

	December 31, 2018	December 31, 2017
ASSETS		
CASH AND CASH EQUIVALENTS		
Cash and due from banks	$2,980	$2,171
Overnight funds	10,790	2,340
Total cash and cash equivalents	13,770	4,511
INTEREST-BEARING DEPOSITS WITH OTHER FINANCIAL INSTITUTIONS	364	119
SECURITIES AVAILABLE-FOR-SALE, at fair value	15,694	19,221
SECURITIES HELD-TO-MATURITY, at amortized cost	3,569	4,053
FEDERAL HOME LOAN BANK stock	644	716
LOANS	78,980	72,311
Less allowance for credit losses	773	739
Total loans, net	78,207	71,572
PREMISES AND EQUIPMENT, net	1,622	1,719
ACCRUED INTEREST RECEIVABLE	350	281
OTHER ASSETS	1,258	1,118
Total assets	$115,478	$103,310
LIABILITIES AND SHAREHOLDERS' EQUITY		
DEPOSITS		
Noninterest-bearing	$27,726	$21,540
Interest-bearing	64,674	57,203
Total deposits	92,400	78,743
FEDERAL HOME LOAN BANK ADVANCES	13,000	15,000
ACCRUED INTEREST PAYABLE	11	21
OTHER LIABILITIES	293	257
Total liabilities	105,704	94,021
SHAREHOLDERS' EQUITY		
Common stock, $1 par value, 10,000,000 shares authorized, 1,435,582 and 1,428,011 shares issued and outstanding at December 31, 2018 and 2017, respectively	1,436	1,428
Additional paid-in capital	11,847	11,790
Accumulated deficit	(2,947)	(3,474)
Accumulated other comprehensive loss	(562)	(455)
Total shareholders' equity	9,774	9,289
Total liabilities and shareholders' equity	$115,478	$103,310

See accompanying notes.

STATEMENTS OF INCOME (dollars in thousands)

	Years Ended December 31,	
	2018	2017
INTEREST AND FEE INCOME		
Loans and leases, including fees	$4,163	$3,689
Investments	385	455
Interest-bearing deposits with other financial institutions and overnight funds	184	24
Total interest and fee income	4,732	4,168
INTEREST EXPENSE		
Deposits	542	423
Federal Home Loan Bank advances	167	176
Total interest expense	709	599
NET INTEREST INCOME	4,023	3,569
PROVISION FOR CREDIT LOSSES	39	12
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	3,984	3,557
NONINTEREST INCOME		
Loss on sale of investment securities	-	(3)
Service charges on deposits	44	43
Bargain purchase gain	100	-
Other income	111	72
Total noninterest income	255	112
NONINTEREST EXPENSE		
Salaries and employee benefits	1,926	1,894
Occupancy and equipment	496	469
Data processing	343	262
Advertising and business development	63	65
Professional and regulatory expenses	332	239
Other expenses	400	316
Total noninterest expense	3,560	3,245
NET INCOME BEFORE PROVISION FOR INCOME TAXES	679	424
PROVISION FOR INCOME TAXES	152	718
NET INCOME (LOSS)	$527	$(294)

See accompanying notes.

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

	Years Ended December 31,	
	2018	2017
NET INCOME (LOSS)	$527	$(294)
Other comprehensive income (loss)		
Unrealized (loss) gain on securities available-for-sale		
Unrealized holding (loss) gain	(135)	9
Tax benefit (expense) on unrealized holding gain (loss)	28	(3)
Reclassification adjustments for realized losses on sales	-	3
Tax benefit for realized losses on sales	-	(1)
Other comprehensive (loss) income	(107)	8
COMPREHENSIVE INCOME (LOSS)	$420	$(286)

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, 2016	1,411,261	$1,411	$11,655	$(3,255)	$(388)	$9,423
Net loss	-	-	-	(294)	-	(294)
Proceeds from stock issuance	16,750	17	101	-	-	118
Other comprehensive loss, net					8	8
Stock-based compensation	-	-	34	-	-	34
Reclassification from the Tax Cuts and Jobs Act of 2017	-	-	-	75	(75)	-
BALANCE, December 31, 2017	1,428,011	1,428	11,790	(3,474)	(455)	9,289
Net income	-	-	-	527	-	527
Proceeds from stock issuance	7,571	8	15	-	-	23
Other comprehensive income, net					(107)	(107)
Stock-based compensation	-	-	42	-	-	42
BALANCE, December 31, 2018	1,435,582	$1,436	$11,847	$(2,947)	$(562)	$9,774

See accompanying notes.

STATEMENTS OF CASH FLOWS (dollars in thousands)

	Years Ended December 31,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$527	$(294)
Adjustments to reconcile net income to net cash from operating activities		
Provision for credit losses	39	12
Depreciation and amortization	176	154
Deferred expense for income taxes	143	718
Net amortization of investment security premium/discount	95	121
Stock-based compensation	42	34
Loss (gain) on sale of investment securities	-	3
Bargain purchase gain	(100)	-
Changes in operating assets and liabilities		
Accrued interest receivable	(69)	(50)
Other assets	50	(12)
Accrued interest payable	(10)	15
Other liabilities	36	51
Net cash provided by operating activities	929	752
CASH FLOWS FROM INVESTING ACTIVITIES		
Net change in interest-bearing deposits with other financial institutions	(245)	(107)
Activity in securities available-for-sale		
Maturities, prepayments, and calls	3,311	3,643
Sales	-	861
Activity in securities held-to-maturity		
Maturities, prepayments, and calls	470	563
Purchases	-	(500)
Redemption of Federal Home Loan Bank stock	72	138
Net cash received from branch acquisition	20,163	-
Loan and lease originations, net	(6,674)	(10,757)
Purchase of premises and equipment, net	(79)	(251)
Net cash used in investing activities	17,018	(6,410)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(6,711)	10,538
Repayments of advances from the Federal Home Loan Bank	(2,000)	(4,000)
Proceeds from stock offering	23	118
Net cash received from financing activities	(8,688)	6,656
NET CHANGE IN CASH AND CASH EQUIVALENTS	9,259	998
CASH AND CASH EQUIVALENTS, beginning of year	4,511	3,513
CASH AND CASH EQUIVALENTS, end of year	$13,770	$4,511
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for interest	$719	$584
Assets acquired in acquisition of branch, at fair value (Note 2)	$20,468	$-
Liabilities assumed in acquisition of branch, at fair value (Note 2)	$20,368	$-
NONCASH INVESTING AND FINANCING ACTIVITIES		
Unrealized (loss) gain on securities available-for-sale	$(135)	$12

See accompanying notes.

Note 1 – Organization and Summary of Significant Accounting Policies

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

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

Subsequent events – Subsequent events are events or transactions that occur after the date of the balance sheet but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 21, 2019, the date the financial statements were available to be issued.

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, 2018 or 2017.

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

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

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

The Bank evaluates FHLB stock for impairment. The determination of whether this investment is impaired is based on the Bank's assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The Bank has determined that there is not an other-than-temporary impairment on the FHLB stock investment as of December 31, 2018 or 2017.

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, 2018 or 2017.

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.

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.

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.

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 $12 and $14 in 2018 and 2017, 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, 2018 and 2017, 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.

Note 2 – Branch Acquisition

On May 15, 2018, the Bank completed the acquisition of a branch in Poulsbo, Washington, from Banner Bank. In accordance with the Purchase and Assumption Agreement dated as of February 15, 2018, the Bank acquired $20,411 of deposits and no loans. As of December 31, 2018, approximately $17,251 of the acquired deposits remain at the Bank. The Bank paid a deposit premium of approximately 1.21% on substantially all of the deposits assumed, which equated to approximately $249.

The branch purchase was accounted for under the acquisition method of accounting, and accordingly, the assets and liabilities were recorded at their fair values as of May 15, 2018. Determining the fair value of assets and liabilities is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values become available.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of acquisition:

Assets	Acquired Book Value	Fair Value Adjustments	Amount Recorded
Cash and cash equivalents	$20,163	$-	$20,163
Core deposit intangible	-	305	305
Total assets acquired	$20,163	$305	$20,468
Liabilities			
Deposits	$20,412	$(44)	$20,368
Total liabilities	$20,412	$(44)	$20,368

Explanation of fair value adjustments – The fair value adjustments represent the difference between the fair value and the book value of the assets acquired. The value of the core deposit intangible was based on a study by an independent consulting firm. This amount was recorded by the Bank as an identifiable intangible asset and will be amortized as an expense on an accelerated basis over the average life of the core deposit base, which is estimated to be seven years.

The following table summarizes the aggregate amount recognized for each major class of assets acquired and liabilities assumed by the Bank in the branch purchase:

	At May 15, 2018
Purchase price	$249
Recognized amounts of identifiable assets acquired and (liabilities assumed), at fair value	
Cash and cash equivalents	20,412
Core deposit intangible	305
Deposits	(20,412)
Discount on certificates of deposit	44
Total fair value of identifiable net assets	349
Bargain purchase gain	$100

Core deposit intangible – The core deposit intangible represents the fair value of the acquired core deposit base. The core deposit intangible will be amortized on an accelerated basis over approximately nine years. Total amortization expense was $57 for the year ended December 31, 2018, and none for the same period in 2017. Amortization expense for core deposit intangible is expected to be as follows:

2019	$73
2020	53
2021	38
2022	29
2023	29
Thereafter	26
Total	$248

Note 3 - Investments

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

December 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
Mortgage-backed securities	$16,405	$-	$(711)	$15,694
Held-to-maturity				
Mortgage-backed securities	$3,108	$-	$(120)	$2,988
SBA security	461	-	(17)	444
Total	$3,569	$-	$(137)	$3,432
December 31, 2017				
Securities available-for-sale				
Mortgage-backed securities	$19,797	$-	$(576)	$19,221
Held-to-maturity				
Mortgage-backed securities	$3,561	$-	$(62)	$3,499
SBA security	492	-	-	492
Total	$4,053	$-	$(62)	$3,991

The amortized cost and estimated fair value of investment securities at December 31, 2018, 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	$2,551	$2,500	$-	$-
Due after 5 to 10 years	585	576	-	-
Due after 10 years	13,269	12,618	3,569	3,432
	$16,405	$15,694	$3,569	$3,432

As of December 31, 2018, securities with a carrying value of $10,405 were pledged to secure borrowings at the FHLB and securities with a carrying value of $5,046 were pledged to secure public deposits. As of December 31, 2017, securities with a carrying value of $12,297 were pledged to secure borrowings at the FHLB and securities with a carrying value of $5,871 were pledged to secure public deposits.

During the year ended December 31, 2018, the Bank did not sell any investment securities. During the year ended December 31, 2017, the Bank sold $861 in investment securities, realizing gross losses of $3.

At December 31, 2018 and 2017, 43 securities were in an unrealized loss position. Of the 43 securities in a loss position at year-end 2018, 41 had been in a loss position for more than 12 months. The Bank has evaluated these securities and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any bank- or industry-specific event. The Bank anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment. Because management does not intend to sell and does not anticipate to be required to sell these securities in the near term, no declines are deemed to be other than temporary.

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, 2018	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Losses
Securities available-for-sale					
Mortgage-backed securities	$-	$-	$711	$15,694	$711
Held-to-maturity					
Mortgage-backed securities	$6	$301	$126	$2,687	$120
SBA security	17	444	-	-	17
Total	$23	$745	$126	$2,687	$137
December 31, 2017					
Securities available-for-sale					
Mortgage-backed securities	$12	$1,163	$564	$18,058	$576
Held-to-maturity					
Mortgage-backed securities	$-	$-	$62	$3,149	$62

Note 4 - Loans, Leases, and Allowance for Credit Losses

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

	2018	2017
Commercial real estate	$39,127	$34,485
Commercial	13,482	13,100
Construction and land	9,360	7,809
Consumer	306	377
Residential real estate	16,698	16,540
Gross loans	78,973	72,311
Premium on purchased loans, net	277	255
Deferred fees and costs, net	(269)	(255)
Allowance for credit losses	(774)	(739)
Total loans, net	$78,207	$71,572

The Bank pledged certain commercial loans as collateral for purposes of borrowings with the FHLB. Loans totaling $30,818 and $16,392 were pledged to the FHLB at December 31, 2018 and 2017, respectively (Note 7).

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

2018	Beginning Balance	Provision (Recovery) for Credit Losses	Charge-offs	Recoveries	Ending Ending Balance
Commercial real estate	$269	$149	$-	$-	$418
Commercial	119	(38)	(7)	3	77
Construction and land	81	49	-	-	130
Consumer	2	(1)	-	-	1
Residential real estate	125	(51)	-	-	74
Unallocated	143	(69)	-	-	74
	$739	$39	$(7)	$3	$774
2017					
Commercial real estate	$278	$(9)	$-	$-	$269
Commercial	64	63	(9)	1	119
Construction and land	110	(29)	-	-	81
Consumer	6	(4)	-	-	2
Residential real estate	52	73	-	-	125
Unallocated	225	(82)	-	-	143
	$735	$12	$(9)	$1	$739

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

2018	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	$600	$600	$-	$300	$17
Commercial	75	75	-	38	-
2017					
With no allowance recorded					
Commercial	$8	$8	$-	$9	$1

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		
2018	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	$418	$-	$418	$39,127	$600	$38,527
Commercial	77	-	77	13,482	75	13,407
Construction and land	130	-	130	9,360	-	9,360
Consumer	1	-	1	306	-	306
Residential real estate	74	-	74	16,698	-	16,698
Unallocated	74	-	74	-	-	-
	$774	$-	$774	$78,973	$675	$78,298
?=>D						
Commercial real estate	$269	$-	$269	$34,485	$-	$34,485
Commercial	119	-	119	13,100	8	13,092
Construction and land	81	-	81	7,809	-	7,809
Consumer	2	-	2	377	-	377
Residential real estate	125	-	125	16,540	-	16,540
Unallocated	143	-	143	-	-	-
	$739	$-	$739	$72,311	$8	$72,303

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

2018	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	$-	$-	$600	$600	$38,527	$39,127
Commercial	-	-	75	75	13,407	13,482
Construction and land	-	-	-	-	9,360	9,360
Consumer	-	-	-	-	306	306
Residential real estate	-	-	-	-	16,698	16,698
	$-	$-	$675	$675	$78,298	$78,973
2017						
Commercial real estate	$-	$-	$-	$-	$34,485	$34,485
Commercial	-	-	8	8	13,092	13,100
Construction and land	-	-	-	-	7,809	7,809
Consumer	-	-	-	-	377	377
Residential real estate	-	-	-	-	16,540	16,540
	$-	$-	$8	$8	$72,303	$72,311

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:

	2018	2017
Commercial real estate	$600	$-
Commercial	75	8
	$675	$8

There were no loans 90 days or more past due and still accruing interest at December 31, 2018 or 2017.

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, 2018, 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, 2018 and 2017, by class of loans:

Credit Risk Profile by Internally Assigned Grade

2018	Commercial Real Estate	Commercial	Construction and Land	Consumer	Residential Real Estate	Total
Grade						
Pass	$35,958	$13,400	$8,849	$306	$16,698	$75,211
Watch	1,369	7	27	-	-	1,403
Special mention	1,200	-	484	-	-	1,684
Substandard	600	75	-	-	-	675
Doubtful	-	-	-	-	-	-
	$39,127	$13,482	$9,360	$306	$16,698	$78,973
2017						
Grade						
Pass	$33,879	$12,192	$7,208	$377	$16,540	$70,196
Watch	-	804	601	-	-	1,405
Special mention	-	-	-	-	-	-
Substandard	606	96	-	-	-	702
Doubtful	-	8	-	-	-	8
	$34,485	$13,100	$7,809	$377	$16,540	$72,311

There were no loans modified by the Bank as troubled debt restructurings at December 31, 2018 and 2017, or modified during the years then ended.

Note 5 – Premises and Equipment

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

	2018	2017
Land	$132	$132
Building	1,292	1,275
Leasehold improvements	721	720
Furniture, fixtures, and office equipment	557	486
Vehicles	23	23
	2,725	2,636
Less accumulated depreciation and amortization	(1,103)	(917)
	$1,622	$1,719

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. The annual lease through the initial lease term and renewal options is as follows:

2019	$265
2020	270
2021	114
	$649

Rental expense, including operating expenses charged to operations, was $262 and $258 for the years ended December 31, 2018 and 2017, respectively.

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

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

2019	$75
2020	75
2021	75
2022	44
	$269

Note 6 – Deposits

Deposits as of December 31 consisted of the following:

	2018	2017
Savings accounts	$8,559	$8,471
Certificates of deposit	11,328	13,894
Demand accounts		
Noninterest-bearing	27,726	21,540
Interest-bearing	13,541	8,829
Money market accounts	31,246	26,009
	$92,400	$78,743

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

2019	$6,941
2020	4,136
2021	220
2022	16
2023	-
Thereafter	15
	$11,328

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

Note 7 – Credit Arrangements

At December 31, 2018, committed line-of-credit agreements totaling approximately $9.8 million were available to the Bank from unaffiliated banks, subject to interest at then-current rates. Such lines generally provide for interest at the lending bank's prime rate or other money market rates. These arrangements require total compensating balances of at least $485 maintained in a demand deposit account. The compensating balances are included in cash and cash equivalents at December 31, 2018.

The Bank is a member of the FHLB of Des Moines, and as such, is eligible for a credit line up to 35% of total assets, subject to certain collateral requirements. At December 31, 2018, loans and investments pledged as collateral to the FHLB equated to a borrowing capacity of $40,417, 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, 2018, the Bank had $13,000 of total advances outstanding with the FHLB, of which $5,000 were short-term revolving advances and $8,000 were long-term advances with a weighted-average rate of 1.66%. 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. At December 31, 2018, the Bank had committed $1,000 of forward starting advances with the FHLB at predetermined fixed rates to be advanced in 2019 and 2020.

The contractual maturities of long-term FHLB advances at December 31, 2018, are as follows:

2018	$3,500
2019	2,500
2020	2,000
	$8,000

Note 8 - Income Taxes

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

	2018	2017
Deferred	$152	$718
Change in valuation allowance	-	-
Total tax expense (benefit)	$152	$718

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

	2018		2017	
	Amount	Percent of Pre-Tax Income	Amount	Percent of Pre-Tax Income
Income tax at statutory rates	$152	$21	$144	34
Increase resulting from				
Permanent differences	-	1	13	3
Change in federal tax rate	-	-	561	132
Total income tax expense (benefit)	$152	$22	$718	169

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

	2018	2017
Deferred tax assets		
Net operating loss carryforward	$446	$552
Organization expenditures	103	122
Property and equipment depreciation	(7)	36
Unrealized loss on securities	149	121
Other, net	2	16
Allowance for credit losses	152	144
Subtotal	845	991
Deferred tax liabilities		
Cash basis method of accounting	37	25
Deferred costs	24	54
Subtotal	61	79
Net deferred tax asset	$784	$912

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

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, 2018 and 2017.

At December 31, 2018, the Bank has, for tax reporting purposes, a net operating loss carryforward totaling approximately $2,125, eligible to offset future federal income taxes. The net operating loss carryforward will begin to expire in 2030.

At December 31, 2018, the Bank had unamortized preopening expenditures of approximately $490 (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 2015.

Note 9 – 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. 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 contributions of $50 and $0 for the years ended December 31, 2018 and 2017.

Note 10 – 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 24,280 remaining shares in the Plan available to grant at December 31, 2018. 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 five years of continuous service from the grant date and expire after ten years.

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

There were no options granted in 2018.

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

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

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, 2017	$189,720	$6.28	7.00
Granted	-	-	-
Exercised	-	-	-
Forfeited	(9,000)	5.87	-
Outstanding at December 31, 2018	$180,720	$6.30	6.09
Options exercisable at December 31, 2018	$138,320	$5.94	5.36

Restricted stock grants – The fair value of restricted stock grants is determined based on the last trade price or most recent stock valuation on the grant date. A summary of nonvested restricted stock grants activity is presented below:

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at December 31, 2017	-	$-
Granted	30,000	6.00
Exercised	-	-
Forfeited	-	-
Nonvested at December 31, 2018	30,000	$6.00

At December 31, 2018, there was approximately $245 of total unrecognized compensation cost related to share-based compensation arrangements. The cost is expected to be recognized over a period of approximately five years.

Note 11 – Shareholders' Equity

Warrants – At December 31, 2018 and 2017, there were warrants outstanding to purchase 172,000 shares of the Bank's common stock at $10 per share, which were issued in connection with the Bank's initial offering. The warrants have a term of 10 years and expire on June 5, 2019.

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Common equity Tier 1, and Tier 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, 2018 and 2017, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2018, 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	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2018								
Total capital								
(to risk-weighted assets)	$10,477	13.66%	$6,138	8.00%	$7,580	9.88%	$7,673	10.00%
Tier I capital								
(to risk-weighted assets)	9,696	12.64%	4,604	6.00%	6,046	7.88%	6,138	8.00%
Common equity Tier 1 capital								
(to risk-weighted assets)	9,696	12.64%	3,453	4.50%	4,895	6.38%	4,987	6.50%
Tier I capital								
(to average assets)	9,696	8.55%	4,537	4.00%	N/A		5,671	5.00%
As of December 31, 2017								
Total capital								
(to risk-weighted assets)	$9,805	13.96%	$5,619	8.00%	$6,497	9.25%	$7,024	10.00%
Tier I capital								
(to risk-weighted assets)	9,058	12.90%	4,214	6.00%	5,092	7.25%	5,619	8.00%
Common equity Tier 1 capital								
(to risk-weighted assets)	9,058	12.90%	3,161	4.50%	4,039	5.75%	4,566	6.50%
Tier I capital								
(to average assets)	9,058	9.21%	3,934	4.00%	N/A		4,918	5.00%

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

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2018 is 1.875% The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, that the Bank meets all capital adequacy requirements to which it is subject.

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:

	2018	2017
Balance, beginning of year	$2,922	$3,271
New loans	639	-
Repayments	(309)	(349)
Balance, end of year	$3,252	$2,922

There were $16,748 and $12,104 of related party deposits at December 31, 2018 and 2017, respectively.

Note 13 – Commitments and Contingencies

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

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

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 48% 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 2018 or 2017.

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

	2018	2017
Commitments to extend credit		
Real estate secured	$6,229	$3,925
Commercial real estate, construction, and land development	4,776	6,637
Other	5,207	3,116
Total commitments to extend credit	$16,212	$13,678

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

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

Note 14 – Fair Value Measurements

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

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

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

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

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

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

Level 3 – Unobservable inputs.

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

There were no transfers between levels during the years ended December 31, 2018 or 2017.

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:

2018	Level 1	Level 2	Level 3	Total
Mortgage-backed securities	$-	$15,694	$-	$15,694
2017				
Mortgage-backed securities	$-	$19,221	$-	$19,221

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

December 31, 2018	Level 1	Level 2	Level 3	Total
Impaired loans	$-	$-	$675	$675
December 31, 2017	Level 1	Level 2	Level 3	Total
Impaired loans	$-	$-	$8	$8

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

Quantitative information about Level 3 fair value measurements – The range and weighted average of the significant unobservable inputs used to fair value Level 3 nonrecurring assets during the years ending December 31, 2018 and 2017, along with the valuation techniques used, are shown in the following table:

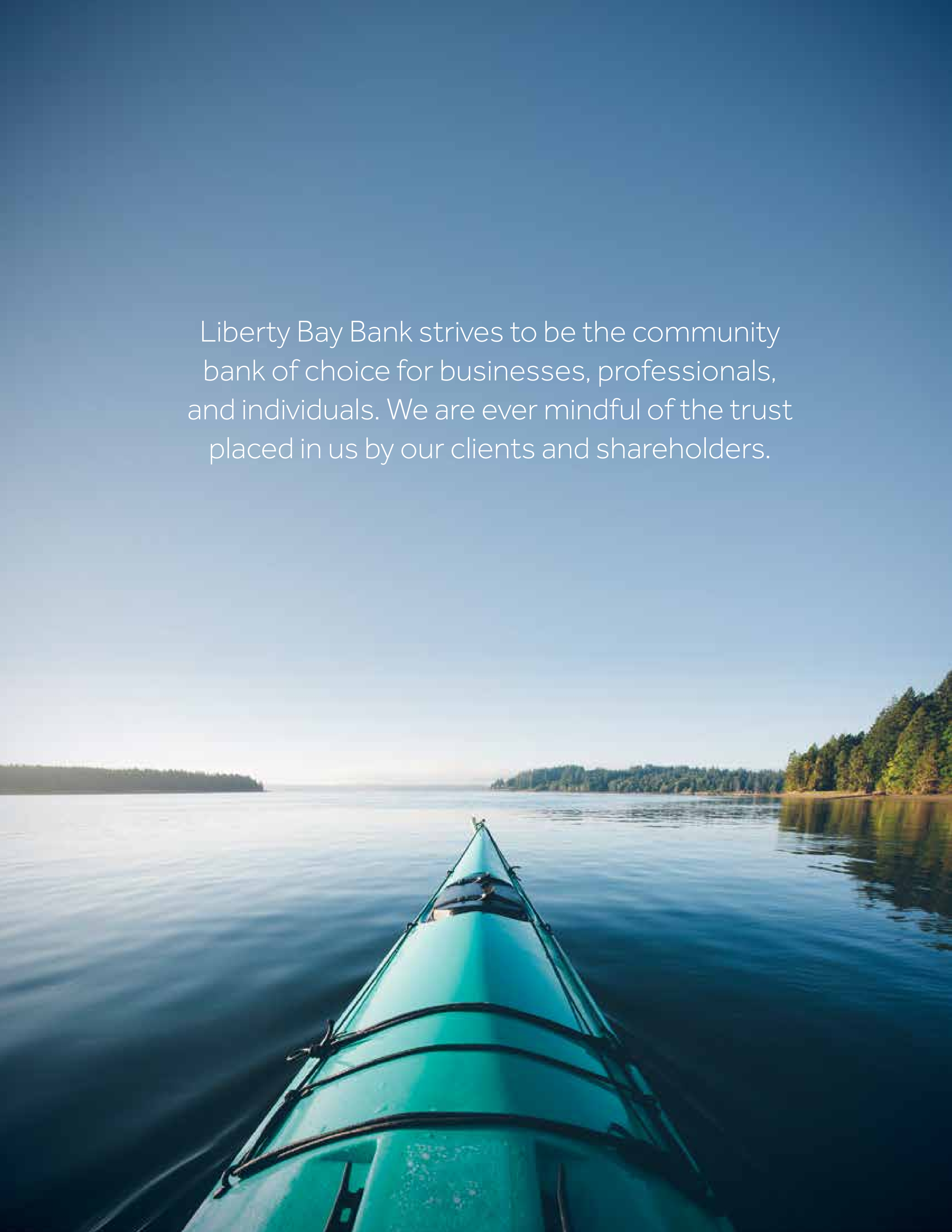
	Fair Value at December 31, 2018	Valuation Technique	Unobservable Input	Range[1]
Impaired loans	$675	Real estate appraisal	Discount to appraisal	0% - 10%

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

[1] Discount for selling costs.

Fair value 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.

Liberty Bay Bank strives to be the community bank of choice for businesses, professionals, and individuals. We are ever mindful of the trust placed in us by our clients and shareholders.



Building Relationships That
Strengthen Our Community™

Liberty Bay Bank

(360) 779-4567
libertybaybank.com

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