



REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS

LIBERTY BAY BANK

December 31, 2019 and 2018



MOSSADAMS

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Report of Independent Auditors

To the Board of Directors and Shareholders
Liberty Bay Bank

Report on the Financial Statements

We have audited the accompanying financial statements of Liberty Bay Bank, which comprise the balance sheets as of December 31, 2019 and 2018, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Liberty Bay Bank as of December 31, 2019 and 2018, 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 26, 2020

Liberty Bay Bank

Balance Sheets (dollars in thousands)

ASSETS		
	December 31,	
	2019	2018
CASH AND CASH EQUIVALENTS		
Cash and due from banks	\$ 3,218	\$ 2,980
Overnight funds	27,485	10,790
Total cash and cash equivalents	30,703	13,770
INTEREST-BEARING DEPOSITS WITH OTHER FINANCIAL INSTITUTIONS	495	364
INVESTMENT SECURITIES AVAILABLE-FOR-SALE, at fair value	9,385	15,694
INVESTMENT SECURITIES HELD-TO-MATURITY, at amortized cost	3,077	3,569
FEDERAL HOME LOAN BANK STOCK	619	644
LOANS	81,766	78,980
Less allowance for credit losses	788	773
Total loans, net	80,978	78,207
PREMISES AND EQUIPMENT, net	1,510	1,622
ACCRUED INTEREST RECEIVABLE	341	350
OTHER ASSETS	1,119	1,258
Total assets	<u>\$ 128,227</u>	<u>\$ 115,478</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
DEPOSITS		
Noninterest-bearing	\$ 27,059	\$ 27,726
Interest-bearing	77,258	64,674
Total deposits	104,317	92,400
FEDERAL HOME LOAN BANK ADVANCES	12,000	13,000
ACCRUED INTEREST PAYABLE	13	11
OTHER LIABILITIES	344	293
Total liabilities	116,674	105,704
SHAREHOLDERS' EQUITY		
Common stock, \$1 par value, 10,000,000 shares authorized, 1,602,419 and 1,435,582 shares issued and outstanding at December 31, 2019 and 2018, respectively	1,602	1,436
Additional paid-in capital	12,851	11,847
Accumulated deficit	(2,799)	(2,947)
Accumulated other comprehensive loss	(101)	(562)
Total shareholders' equity	11,553	9,774
Total liabilities and shareholders' equity	<u>\$ 128,227</u>	<u>\$ 115,478</u>

Liberty Bay Bank
Statements of Income (dollars in thousands)

	Years Ended December 31,	
	2019	2018
INTEREST AND FEE INCOME		
Loans, including fees	\$ 4,583	\$ 4,163
Investments	307	385
Interest-bearing deposits with other financial institutions and overnight funds	228	184
Total interest and fee income	5,118	4,732
INTEREST EXPENSE		
Deposits	922	542
Federal Home Loan Bank advances	137	167
Total interest expense	1,059	709
NET INTEREST INCOME	4,059	4,023
PROVISION FOR CREDIT LOSSES	15	39
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	4,044	3,984
NONINTEREST INCOME		
Service charges on deposits	58	44
Debit and credit card interchange income, net	40	30
Bargain purchase gain	-	100
Loss on sale of securities available-for-sale	(43)	-
Other income	146	111
Total noninterest income	201	285
NONINTEREST EXPENSE		
Salaries and employee benefits	2,367	1,926
Occupancy and equipment	544	496
Data processing	415	373
Advertising and business development	70	63
Professional and regulatory expenses	207	332
Other expenses	453	400
Total noninterest expense	4,056	3,590
NET INCOME BEFORE PROVISION FOR INCOME TAXES	189	679
PROVISION FOR INCOME TAXES	41	152
NET INCOME	\$ 148	\$ 527

Liberty Bay Bank

Statements of Comprehensive Income (dollars in thousands)

	Years Ended December 31,	
	2019	2018
NET INCOME	<u>\$ 148</u>	<u>\$ 527</u>
Other comprehensive income (loss)		
Unrealized gain (loss) on securities available-for-sale		
Unrealized holding gain (loss)	540	(135)
Tax benefit (expense) on unrealized holding gain (loss)	(113)	28
Reclassification adjustments for realized losses		
on sales of securities available-for-sale	43	-
Tax benefit for realized losses on sales	<u>(9)</u>	<u>-</u>
Other comprehensive income (loss)	<u>461</u>	<u>(107)</u>
COMPREHENSIVE INCOME	<u><u>\$ 609</u></u>	<u><u>\$ 420</u></u>

Liberty Bay Bank

Statements of Changes in Shareholders' Equity (dollars in thousands)

	Common Stock		Additional	Accumulated	Accumulated	Total
	Shares	Amount	Paid-in	Deficit	Other Comprehensive Income	Shareholders' Equity
BALANCE, December 31, 2017	1,428,011	\$ 1,428	\$ 11,790	\$ (3,474)	\$ (455)	\$ 9,289
Net income	-	-	-	527	-	527
Proceeds from stock issuance, net	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
Net income	-	-	-	148	-	148
Proceeds from stock issuance, net	160,666	160	960	-	-	1,120
Exercise of options (cashless)	171	-	-	-	-	-
Vesting of restricted stock	6,000	6	(6)	-	-	-
Other comprehensive income, net	-	-	-	-	461	461
Stock-based compensation	-	-	50	-	-	50
BALANCE, December 31, 2019	1,602,419	\$ 1,602	\$ 12,851	\$ (2,799)	\$ (101)	\$ 11,553

Liberty Bay Bank

Statements of Cash Flows (dollars in thousands)

	Years Ended December 31,	
	2019	2018
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 148	\$ 527
Adjustments to reconcile net income to net cash		
from operating activities		
Provision for credit losses	15	39
Depreciation and amortization	184	176
Deferred expense for income taxes	41	143
Net amortization of investment security premium/discount	74	95
Stock-based compensation	50	42
Loss on sale of investment securities	43	-
Bargain purchase gain	-	(100)
Changes in operating assets and liabilities		
Accrued interest receivable	9	(69)
Other assets	(24)	50
Accrued interest payable	2	(10)
Other liabilities	51	36
Net cash provided by operating activities	593	929
CASH FLOWS FROM INVESTING ACTIVITIES		
Net change in interest-bearing deposits with other financial institutions	(131)	(245)
Activity in securities available-for-sale		
Maturities, prepayments, and calls	2,854	3,311
Sales	4,485	-
Purchases	(552)	-
Activity in securities held-to-maturity		
Maturities, prepayments, and calls	480	470
Redemption of Federal Home Loan Bank stock	25	72
Net cash received from branch acquisition	-	20,163
Loan originations, net	(2,786)	(6,674)
Purchase of premises and equipment, net	(72)	(79)
Net cash used in investing activities	4,303	17,018
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	11,917	(6,711)
Repayments of advances from the Federal Home Loan Bank	(1,000)	(2,000)
Proceeds from stock issuance	1,120	23
Net cash received from financing activities	12,037	(8,688)
NET CHANGE IN CASH AND CASH EQUIVALENTS	16,933	9,259
CASH AND CASH EQUIVALENTS, beginning of year	13,770	4,511
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 30,703</u>	<u>\$ 13,770</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for interest	<u>\$ 1,058</u>	<u>\$ 719</u>
Assets acquired in acquisition of branch, at fair value (Note 2)	<u>\$ -</u>	<u>\$ 20,468</u>
Liabilities assumed in acquisition of branch, at fair value (Note 2)	<u>\$ -</u>	<u>\$ 20,368</u>
NONCASH INVESTING AND FINANCING ACTIVITIES		
Unrealized gain (loss) on securities available-for-sale	<u>\$ 583</u>	<u>\$ (135)</u>

See accompanying notes.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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, a leased space in Bellevue, Washington, and loan production office in Port Orchard, Washington. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial real estate loans, residential real estate loans, and commercial loans. The Bank is subject to significant competition from other financial institutions. The Bank is also subject to the regulations of certain federal and state of Washington agencies and undergoes periodic examinations by those regulatory authorities.

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 26, 2020, 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, 2019 or 2018.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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

Investments— 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. 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, 2019 or 2018.

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, 2019 or 2018.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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

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.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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

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.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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

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 \$18 and \$12 in 2019 and 2018, 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, 2019 and 2018, are included within the statements of comprehensive income.

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

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

Revenue recognition – On January 1, 2019, the Company adopted Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, and all subsequent amendments to the ASU (collectively, ASC 606), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. To determine revenue recognition for arrangements that an entity determines are within the scope of Topic 606, the Company performs the following five steps: (i) identify the contract(s) with a customer; (ii) identify the performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the performance obligations in the contract; and (v) recognize revenue when (or as) the Company satisfies a performance obligation. The majority of the Company's revenues come from interest income, including loans and securities that are outside the scope of ASC 606. The Company's services that fall within the scope of ASC 606 are presented within noninterest income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit service charges. Refer to Note 15, Revenue from Contracts with Customers, for further discussion on the Company's accounting policies for revenue sources within the scope of ASC 606.

The Company adopted ASC 606 using the modified retrospective method applied to all contracts not completed as of January 1, 2019. Results for reporting periods beginning on or after January 1, 2019, are presented under ASC 606, while prior period amounts continue to be reported in accordance with legacy GAAP. The adoption of ASC 606 did not result in a material change to the accounting for any of the in-scope revenue streams; as such, no cumulative effect adjustment was recorded.

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. 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 becomes available.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 2 – Branch Acquisition (continued)

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

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

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	<u>\$ 249</u>
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	<u>44</u>
Total fair value of identifiable net assets	<u>349</u>
Bargain purchase gain	<u>\$ 100</u>

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 2 – Branch Acquisition (continued)

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 \$69 and \$57 for the years ended December 31, 2019 and 2018, respectively. Amortization expense for the core deposit intangible is expected to be as follows:

2020	\$ 53
2021	38
2022	29
2023	29
Thereafter	<u>26</u>
Total	<u><u>\$ 175</u></u>

Note 3 – Investments

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2019				
Securities available-for-sale				
Mortgage-backed securities	<u>\$ 9,513</u>	<u>\$ 2</u>	<u>\$ (130)</u>	<u>\$ 9,385</u>
Held-to-maturity				
Mortgage-backed securities	\$ 2,658	\$ 2	\$ (26)	\$ 2,634
SBA security	<u>419</u>	<u>8</u>	<u>-</u>	<u>427</u>
Total	<u><u>\$ 3,077</u></u>	<u><u>\$ 10</u></u>	<u><u>\$ (26)</u></u>	<u><u>\$ 3,061</u></u>
December 31, 2018				
Securities available-for-sale				
Mortgage-backed securities	<u>\$ 16,405</u>	<u>\$ -</u>	<u>\$ (711)</u>	<u>\$ 15,694</u>
Held-to-maturity				
Mortgage-backed securities	\$ 3,108	\$ -	\$ (120)	\$ 2,988
SBA security	<u>461</u>	<u>-</u>	<u>(17)</u>	<u>444</u>
Total	<u><u>\$ 3,569</u></u>	<u><u>\$ -</u></u>	<u><u>\$ (137)</u></u>	<u><u>\$ 3,432</u></u>

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 3 – Investment Securities (continued)

The amortized cost and estimated fair value of investment securities at December 31, 2019, 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	\$ 1,647	\$ 1,629	\$ -	\$ -
Due after 5 to 10 years	6,450	6,340	2,138	2,112
Due after 10 years	1,416	1,416	939	948
	<u>\$ 9,513</u>	<u>\$ 9,385</u>	<u>\$ 3,077</u>	<u>\$ 3,060</u>

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

During the year ended December 31, 2019, the Bank sold nine investment securities totaling \$4,485, with gross losses of \$43 recognized on the sales. There were no sales of investment securities in 2018.

At December 31, 2019 and 2018, 29 and 43 securities were in an unrealized loss position, with 26 and 41 in a loss position of more than 12 months, respectively. The Bank has evaluated these securities and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any bank- or industry-specific event. The Bank anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment. Because management does not intend to sell and does not anticipate to be required to sell these securities in the near term, no declines are deemed to be other than temporary.

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 3 – Investment Securities (continued)

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

	Less Than 12 Months		Over 12 Months		Total
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2019					
Securities available-for-sale					
Mortgage-backed securities	\$ 4	\$ 784	\$ 126	\$ 7,710	\$ 130
Held-to-maturity					
Mortgage-backed securities	\$ -	\$ -	\$ 26	\$ 1,408	\$ 26
December 31, 2018					
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 securities held-to-maturity	\$ 23	\$ 745	\$ 126	\$ 2,687	\$ 137

Note 4 – Loans and Allowance for Credit Losses

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

	2019	2018
Commercial real estate	\$ 38,989	\$ 39,127
Commercial	16,074	13,759
Construction and land	7,127	9,360
Consumer	206	306
Residential real estate	19,630	16,698
Gross loans	82,026	79,250
Deferred fees and costs, net	(260)	(269)
Allowance for credit losses	(788)	(774)
Total loans, net	\$ 80,978	\$ 78,207

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 4 – Loans and Allowance for Credit Losses (continued)

The Bank pledged certain commercial loans as collateral for purposes of borrowings with the FHLB. Loans totaling \$34,065 and \$30,818 were pledged to the FHLB at December 31, 2019 and 2018, respectively (Note 7).

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

	Beginning Balance	Provision (Recovery) for Credit Losses	Charge-offs	Recoveries	Ending Balance
2019					
Commercial real estate	\$ 418	(7)	\$ -	\$ -	\$ 411
Commercial	76	40	-	-	116
Construction and land	130	(70)	-	-	60
Consumer	1	-	-	-	1
Residential real estate	74	60	-	-	134
Unallocated	74	(8)	-	-	66
	<u>\$ 773</u>	<u>\$ 15</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 788</u>
2018					
Commercial real estate	\$ 269	\$ 149	\$ -	\$ -	\$ 418
Commercial	119	(38)	(8)	3	76
Construction and land	81	49	-	-	130
Consumer	2	(1)	-	-	1
Residential real estate	125	(51)	-	-	74
Unallocated	143	(69)	-	-	74
	<u>\$ 739</u>	<u>\$ 39</u>	<u>\$ (8)</u>	<u>\$ 3</u>	<u>\$ 773</u>

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 4 – Loans and Allowance for Credit Losses (continued)

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

	Recorded Investments (Loan Balance Less Charge-off)	Unpaid Principal Balance	Related Allowance	Average Investment in Impaired Loans	Interest Income Recognized
2019					
With no allowance recorded					
Commercial real estate	\$ 1,865	\$ 1,865	\$ -	\$ 933	\$ 107
Commercial	603	603	-	-	-
	<u>\$ 2,468</u>	<u>\$ 2,468</u>	<u>\$ -</u>	<u>\$ 933</u>	<u>\$ 107</u>
2018					
With no allowance recorded					
Commercial real estate	\$ 600	\$ 600	\$ -	\$ 300	\$ 17
Commercial	75	75	-	38	-
	<u>\$ 675</u>	<u>\$ 675</u>	<u>\$ -</u>	<u>\$ 338</u>	<u>\$ 17</u>

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		
	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
2019						
Commercial real estate	\$ 411	\$ -	\$ 411	\$ 38,989	\$ 1,865	\$ 37,124
Commercial	116	-	116	16,074	603	15,471
Construction and land	60	-	60	7,127	-	7,127
Consumer	1	-	1	206	-	206
Residential real estate	134	-	134	19,630	-	19,630
Unallocated	66	-	66	-	-	-
	<u>\$ 788</u>	<u>\$ -</u>	<u>\$ 788</u>	<u>\$ 82,026</u>	<u>\$ 2,468</u>	<u>\$ 79,558</u>
2018						
Commercial real estate	\$ 418	\$ -	\$ 418	\$ 39,127	\$ 600	\$ 38,527
Commercial	76	-	76	13,759	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	-	-	-
	<u>\$ 773</u>	<u>\$ -</u>	<u>\$ 773</u>	<u>\$ 79,250</u>	<u>\$ 675</u>	<u>\$ 78,298</u>

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 4 – Loans and Allowance for Credit Losses (continued)

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

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans
2019						
Commercial real estate	\$ -	\$ 597	\$ 578	\$ 1,175	\$ 37,814	\$ 38,989
Commercial	-	-	75	75	15,999	16,074
Construction and land	-	-	-	-	7,127	7,127
Consumer	-	-	-	-	206	206
Residential real estate	-	-	-	-	19,630	19,630
	<u>\$ -</u>	<u>\$ 597</u>	<u>\$ 653</u>	<u>\$ 1,250</u>	<u>\$ 80,776</u>	<u>\$ 82,026</u>
2018						
Commercial real estate	\$ -	\$ -	\$ 600	\$ 600	\$ 38,527	\$ 39,127
Commercial	-	-	75	75	13,684	13,759
Construction and land	-	-	-	-	9,360	9,360
Consumer	-	-	-	-	306	306
Residential real estate	-	-	-	-	16,698	16,698
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 675</u>	<u>\$ 675</u>	<u>\$ 78,575</u>	<u>\$ 79,250</u>

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:

	2019	2018
Commercial real estate	\$ 578	\$ 600
Commercial	75	75
	<u>\$ 653</u>	<u>\$ 675</u>

There were no loans 90 days or more past due and still accruing interest at December 31, 2019 or 2018.

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.

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 4 – Loans and Allowance for Credit Losses (continued)

When the Bank classifies problem assets as either substandard or doubtful, it may establish a specific allowance to address the risk specifically or the Bank may allow the loss to be addressed in the general allowance. General allowances represent loss allowances that have been established to recognize the inherent risk associated with lending activities, but, unlike specific allowances, have not been specifically allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose the Bank to sufficient risk to warrant classification as substandard or doubtful but possess identified weaknesses are designated as either watch or special mention assets. At December 31, 2019, 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, 2019 and 2018, by class of loans:

Credit Risk Profile by Internally Assigned Grade

2019	Commercial Real Estate	Commercial	Construction and Land	Consumer	Residential Real Estate	Total
Grade						
Pass	\$ 34,170	\$ 15,786	\$ 6,599	\$ 172	\$ 19,630	\$ 76,357
Watch	3,054	213		34	-	3,301
Special mention	-	-	-	-	-	-
Substandard	1,765	75	528	-	-	2,368
Doubtful	-	-	-	-	-	-
	<u>\$ 38,989</u>	<u>\$ 16,074</u>	<u>\$ 7,127</u>	<u>\$ 206</u>	<u>\$ 19,630</u>	<u>\$ 82,026</u>
2018						
Grade						
Pass	\$ 35,958	\$ 13,677	\$ 8,849	\$ 306	\$ 16,698	\$ 75,488
Watch	1,369	7	27	-	-	1,403
Special mention	1,200	-	484	-	-	1,684
Substandard	600	75	-	-	-	675
Doubtful	-	-	-	-	-	-
	<u>\$ 39,127</u>	<u>\$ 13,759</u>	<u>\$ 9,360</u>	<u>\$ 306</u>	<u>\$ 16,698</u>	<u>\$ 79,250</u>

There were no loans modified by the Bank as troubled debt restructurings at December 31, 2019 and 2018, or modified during the years then ended.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 5 – Premises and Equipment

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

	2019	2018
Land	\$ 132	\$ 132
Building	1,292	1,292
Leasehold improvements	713	721
Furniture, fixtures, and office equipment	620	557
Vehicles	23	23
Construction in progress	8	-
	2,788	2,725
Less accumulated depreciation and amortization	(1,278)	(1,103)
	<u>\$ 1,510</u>	<u>\$ 1,622</u>

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. Additionally, the Bank executed a sublease agreement in Bellevue, Washington, effective November 2019 with terms extending through January 2022. The annual lease payments through both terms outlined above are as follows:

2020	\$ 430
2021	274
2022	13
	<u>\$ 717</u>

Rental expense, including operating expenses charged to operations, was \$310 and \$262 for the years ended December 31, 2019 and 2018, respectively.

The Bank leases a portion of the Port Orchard loan production office. 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:

2020	\$ 160
2021	160
2022	13
	<u>\$ 333</u>

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 6 – Deposits

Deposits as of December 31 consisted of the following:

	2019	2018
Savings accounts	\$ 8,054	\$ 8,559
Certificates of deposit	14,905	11,328
Demand accounts		
Noninterest-bearing	27,059	27,726
Interest-bearing	12,821	13,541
Money market accounts	41,478	31,246
	<u>\$ 104,317</u>	<u>\$ 92,400</u>

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

2020	\$ 13,915
2021	945
2022	<u>45</u>
	<u>\$ 14,905</u>

The Bank had \$5,229 and \$5,160 of certificates of deposit that met or exceeded the \$250,000 federally insured limit at December 31, 2019 and 2018, respectively.

Note 7 – Credit Arrangements

At December 31, 2019, committed line-of-credit agreements totaling approximately \$10.0 million were available to the Bank from unaffiliated banks, subject to interest at then-current rates. Such lines generally provide for interest at the lending bank's prime rate or other money market rates. These arrangements require total compensating balances of at least \$485 maintained in a demand deposit account. The compensating balance is included in cash and cash equivalents at December 31, 2019.

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, 2019, loans and investments pledged as collateral to the FHLB equated to a borrowing capacity of \$44,878, 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.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 7 – Credit Arrangements (continued)

At December 31, 2019, the Bank had \$12,000 of total advances outstanding with the FHLB, of which \$5,000 were short-term revolving advances and \$7,000 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, 2019, the Bank had committed \$1,500 of forward starting advances with the FHLB at predetermined fixed rates. Funds committed to in 2019 were to be advanced in 2020 and 2023.

The contractual maturities of long-term FHLB advances at December 31, 2019, are as follows:

2020	\$ 2,500
2021	<u>4,500</u>
	<u>\$ 7,000</u>

Note 8 – Income Taxes

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

	<u>2019</u>	<u>2018</u>
Deferred	\$ 41	\$ 152
Current	<u>-</u>	<u>-</u>
Total tax expense	<u>\$ 41</u>	<u>\$ 152</u>

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

	<u>2019</u>		<u>2018</u>	
	<u>Amount</u>	<u>Percent of Pre-Tax Income</u>	<u>Amount</u>	<u>Percent of Pre-Tax Income</u>
Income tax at statutory rates	\$ 40	\$ 21	\$ 152	\$ 21
Increase resulting from				
Permanent differences	1	1	-	1
Change in federal tax rate	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total income tax expense	<u>\$ 41</u>	<u>\$ 22</u>	<u>\$ 152</u>	<u>22</u>

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 8 – Income Taxes (continued)

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

	2019	2018
Deferred tax assets		
Net operating loss carryforward	\$ 410	\$ 446
Organization expenditures	84	103
Property and equipment depreciation	32	(7)
Unrealized loss on securities	27	149
Other, net	21	2
Allowance for credit losses	155	152
	<hr/>	<hr/>
Subtotal	729	845
	<hr/>	<hr/>
Deferred tax liabilities		
Cash basis method of accounting	82	37
Deferred costs	26	24
	<hr/>	<hr/>
Subtotal	108	61
	<hr/>	<hr/>
Net deferred tax asset	<u>\$ 621</u>	<u>\$ 784</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 projections, the Bank determined that the deferred tax asset could be supported at December 31, 2019 and 2018.

At December 31, 2019, the Bank has, for tax reporting purposes, a net operating loss carryforward totaling approximately \$1,950, eligible to offset future federal income taxes. The net operating loss carryforward will begin to expire in 2030.

At December 31, 2019, the Bank had unamortized preopening expenditures of approximately \$400 (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 2016.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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. In addition, the Bank has elected discretionary contributions under the 401(k) plan. Contributions vest at 20% per year after the first year and will be fully vested after six years of service. There were discretionary contributions of \$0 and \$50 for the years ended December 31, 2019 and 2018.

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 to certain key employees and directors, 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. 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 10 years.

There were no options granted in 2019 or 2018.

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, 2018	\$ 180,720	\$ 6.30	6.09
Granted	-	-	-
Exercised	(171)	6.60	-
Cancelled	(2,829)	6.60	-
Forfeited	(9,968)	7.17	-
Outstanding at December 31, 2019	<u>\$ 167,752</u>	<u>\$ 6.24</u>	<u>4.99</u>
Options exercisable at December 31, 2019	<u>\$ 152,618</u>	<u>\$ 6.12</u>	<u>4.74</u>

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 10 – Stock-Based Compensation (continued)

Restricted stock grants –A summary of nonvested restricted stock grants activity is presented below:

	Shares	Weighted- Average Grant-Date Fair Value
Nonvested at December 31, 2018	30,000	\$ 6.00
Granted	-	-
Vested	(6,000)	6.00
Forfeited	-	-
Nonvested at December 31, 2019	<u>24,000</u>	<u>\$ 6.00</u>

At December 31, 2019, there was approximately \$148 of total unrecognized compensation cost related to share-based compensation arrangements. The cost is expected to be recognized over a period of approximately four years.

Note 11 – Shareholders' Equity

Warrants – The Bank had warrants outstanding to purchase 172,000 shares of the Bank's common stock at \$10 per share, which were issued in connection with the Bank's initial offering. The warrants expired June 5, 2019.

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, 2019 and 2018, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2019, 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.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 11 – Shareholders' Equity (continued)

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, 2019								
Total capital								
(to risk-weighted assets)	\$ 11,866	15.67%	\$ 6,058	8.00%	\$ 7,951	10.50%	\$ 7,572	10.00%
Tier 1 capital								
(to risk-weighted assets)	11,070	14.62%	4,543	6.00%	6,436	8.50%	6,058	8.00%
Common equity Tier 1 capital								
(to risk-weighted assets)	11,070	14.62%	3,407	4.50%	5,300	7.00%	4,922	6.50%
Tier 1 capital								
(to average assets)	11,070	9.36%	4,733	4.00%	N/A		5,916	5.00%
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 1 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 1 capital								
(to average assets)	9,696	8.55%	4,537	4.00%	N/A		5,671	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 was being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer is fully phased in at December 31, 2019, at 2.50%. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2019, that the Bank meets all capital adequacy requirements to which it is subject.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

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:

	2019	2018
Balance, beginning of year	\$ 3,252	\$ 2,922
New loans	-	639
Repayments	(1,737)	(309)
Balance, end of year	<u>\$ 1,515</u>	<u>\$ 3,252</u>

There were \$2,066 and \$16,748 of related party deposits at December 31, 2019 and 2018, 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.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 13 – Commitments and Contingencies

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 2019 or 2018.

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

	2019	2018
Commitments to extend credit		
Real estate secured	\$ 7,630	\$ 6,229
Commercial real estate, construction, and land development	2,964	4,776
Commercial loans	4,362	4,849
Other	351	358
	<u>15,307</u>	<u>16,212</u>
Total commitments to extend credit	\$ 15,307	\$ 16,212

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.

Liberty Bay Bank
Notes to Financial Statements (dollars in thousands)

Note 14 – Fair Value Measurements (continued)

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, 2019 or 2018.

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
2019				
Mortgage-backed securities	\$ -	\$ 9,385	\$ -	\$ 9,385
2018				
Mortgage-backed securities	\$ -	\$ 15,694	\$ -	\$ 15,694

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 14 – Fair Value Measurements (continued)

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, 2019	Level 1	Level 2	Level 3	Total
Impaired loans	\$ -	\$ -	\$ 2,468	\$ 2,468
December 31, 2018	Level 1	Level 2	Level 3	Total
Impaired loans	\$ -	\$ -	\$ 675	\$ 675

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, 2019 and 2018, along with the valuation techniques used, are shown in the following table:

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

¹ Discount for selling costs.

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

¹ Discount for selling costs.

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 14 – Fair Value Measurements (continued)

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

Note 15 – Revenue from Contracts with Customers

As noted in Note 1, the Bank adopted the provisions of ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), on January 1, 2019, and all subsequent ASUs that modified Topic 606.

All of the Bank's revenue from contracts with customers in the scope of ASC 606 is recognized in noninterest income except for gains/losses on the sale of other real estate owned. Gains/losses on the sale of other real estate owned are included in noninterest expense and are generally recognized when the performance obligation is complete. This is typically at delivery of control over the property to the buyer at time of each real estate closing.

The following table presents the Bank's sources of noninterest income for the 12 months ended December 31 (in thousands):

	2019	2018
NONINTEREST INCOME		
Service charges on deposits	\$ 58	\$ 44
Debit and credit card interchange income, net	40	30
Bargain purchase gain ⁽¹⁾	-	100
Loss on sale of securities available-for-sale ⁽¹⁾	(43)	-
Other income ⁽¹⁾	146	111
Total noninterest income	<u>\$ 201</u>	<u>\$ 285</u>

⁽¹⁾ Not within the scope of ASC 606

Liberty Bay Bank

Notes to Financial Statements (dollars in thousands)

Note 15 – Revenue from Contracts with Customers (continued)

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

Debit and ATM interchange fee income and expenses

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

