



REPORT OF INDEPENDENT AUDITORS  
AND FINANCIAL STATEMENTS

**FIRST SOUND BANK**

December 31, 2021 and 2020

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## Report of Independent Auditors

The Board of Directors  
First Sound Bank

### **Report on the Audit of the Financial Statements**

#### ***Opinion***

We have audited the financial statements of First Sound Bank, which comprise the balance sheets as of December 31, 2021 and 2020, 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.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of First Sound Bank as of December 31, 2021 and 2020, 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.

#### ***Basis for Opinion***

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of First Sound Bank and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### ***Responsibilities of Management for the Financial Statements***

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for 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.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about First Sound Bank's ability to continue as a going concern within one year after the date that the financial statements are issued.

### ***Auditor's Responsibilities for the Audit of the Financial Statements***

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit 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 First Sound Bank's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about First Sound Bank's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

*Moss Adams LLP*

Everett, Washington

April 29, 2022

**First Sound Bank**  
**Balance Sheets (dollars in thousands)**

**ASSETS**

	December 31,	
	2021	2020
Cash and cash equivalents	\$ 8,323	\$ 14,910
Investment securities, available for sale	9,892	8,234
Loans	119,196	125,366
Allowance for credit losses	(1,492)	(1,407)
Net loans	117,704	123,959
Federal Home Loan Bank stock, at cost	380	188
Premises and equipment, net	102	137
Accrued interest receivable	358	502
Other assets	3,187	1,605
Total assets	\$ 139,946	\$ 149,535

**LIABILITIES AND SHAREHOLDERS' EQUITY**

<b>LIABILITIES</b>		
Deposits	\$ 109,335	\$ 106,098
Borrowings	13,708	28,371
Accrued interest payable	23	29
Other liabilities	1,535	1,671
Total liabilities	124,601	136,169
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock (par value \$0.01); 10,000 shares authorized, no shares issued and outstanding in 2021 and 2020	-	-
Common stock (no par value); authorized: 3,250,000 shares in 2021 and 2020; issued and outstanding: 3,154,586 shares in 2021 and 2020	61,340	61,340
Accumulated deficit	(45,594)	(47,937)
Accumulated other comprehensive loss	(401)	(37)
Total shareholders' equity	15,345	13,366
Total liabilities and shareholders' equity	\$ 139,946	\$ 149,535

# First Sound Bank

## Statements of Income (dollars in thousands)

	Years Ended December 31,	
	2021	2020
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 5,104	\$ 4,873
Interest on deposits in other financial institutions	100	79
Interest on investments	21	68
Total interest income	5,225	5,020
<b>INTEREST EXPENSE</b>		
Deposits	510	587
Borrowings	144	37
Total interest expense	654	624
Net interest income before provision for credit losses	4,571	4,396
<b>PROVISION FOR CREDIT LOSSES</b>	71	-
Net interest income after provision for credit losses	4,500	4,396
<b>NONINTEREST INCOME</b>		
Service charge income	67	95
Gain on sale of loans	597	127
Servicing fees	-	11
Other income	91	95
Total noninterest income	755	328
<b>NONINTEREST EXPENSE</b>		
Salaries and benefits	2,263	2,369
Occupancy expenses	587	580
Professional and regulatory expenses	292	270
Data processing	456	454
Foreclosed asset expenses, net	-	562
Insurance expense	107	104
Loan and lease expense	48	31
Other operating expenses	953	560
Total noninterest expense	4,706	4,930
<b>INCOME BEFORE PROVISION FOR INCOME TAX</b>	549	(206)
Benefit from income tax	1,794	-
<b>NET INCOME (LOSS)</b>	<u>\$ 2,343</u>	<u>\$ (206)</u>
<b>EARNINGS PER COMMON SHARE</b>		
Basic	\$ 0.74	\$ (0.07)
Diluted	\$ 0.74	\$ (0.07)
Weighted-average number of common shares outstanding		
Basic	3,154,586	3,154,586
Diluted	3,162,041	3,154,586

**First Sound Bank**  
**Statements of Comprehensive Income (Loss) (dollars in thousands)**

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	Years Ended December 31,	
	<u>2021</u>	<u>2020</u>
NET INCOME (LOSS)	\$ 2,343	\$ (206)
Other comprehensive loss		
Unrealized holding loss on securities available for sale	<u>(364)</u>	<u>(12)</u>
Other comprehensive loss	<u>(364)</u>	<u>(12)</u>
COMPREHENSIVE INCOME (LOSS)	<u>\$ 1,979</u>	<u>\$ (218)</u>

**First Sound Bank**  
**Statements of Changes in Shareholders' Equity (dollars in thousands)**

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	Common Stock		Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Number of Shares	Amount			
BALANCE, December 31, 2019	3,154,333	\$ 61,340	\$ (47,731)	\$ (25)	\$ 13,584
Net loss	-	-	(206)	-	(206)
Unrealized loss on securities	-	-	-	(12)	(12)
BALANCE, December 31, 2020	3,154,333	61,340	(47,937)	(37)	13,366
Net income	-	-	2,343	-	2,343
Unrealized loss on securities	-	-	-	(364)	(364)
BALANCE, December 31, 2021	<u>3,154,333</u>	<u>\$ 61,340</u>	<u>\$ (45,594)</u>	<u>\$ (401)</u>	<u>\$ 15,345</u>



**First Sound Bank**  
**Statements of Cash Flows (dollars in thousands)**

	Years Ended December 31,	
	2021	2020
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ 2,343	\$ (206)
Adjustments to reconcile net (loss) income to net cash from operating activities		
Amortization of premiums on investment securities	65	47
Depreciation and amortization	60	66
Gain on sale of loans	(597)	(127)
Loss on sale of foreclosed assets	-	2
Write-down of foreclosed assets	-	560
Deferred tax benefit	(1,794)	-
Increase (decrease) in cash due to changes in certain assets and liabilities		
Accrued interest receivable	144	(265)
Other assets	203	(1,271)
Other liabilities	(136)	1,233
Accrued interest payable	(6)	19
Net cash from operating activities	<u>282</u>	<u>58</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investment securities, available for sale	(3,949)	(10,213)
Proceeds from paydowns and maturities of investment securities, available for sale	1,862	4,091
Proceeds from sales of investment securities, available for sale	-	1,016
Net change in loans	6,852	(36,600)
Redemption of Federal Home Loan Bank stock	(192)	(30)
Proceeds from sale of foreclosed assets	-	1,207
Additions to premises and equipment, net	(16)	(14)
Net cash from investing activities	<u>4,557</u>	<u>(40,543)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net change in borrowings	(14,663)	28,371
Net change in deposits	3,237	13,244
Net cash from financing activities	<u>(11,426)</u>	<u>41,615</u>
Net increase in cash and cash equivalents	(6,587)	1,130
CASH AND CASH EQUIVALENTS, beginning of year	<u>14,910</u>	<u>13,780</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 8,323</u>	<u>\$ 14,910</u>
<b>SUPPLEMENTAL CASH AND NONCASH DISCLOSURES</b>		
Cash paid during the year for interest	\$ 654	\$ 639
Unrealized loss on securities	\$ (364)	\$ (12)
Right-of-use assets obtained in exchange for lease liabilities		
Right-of-use assets	\$ -	\$ 1,288
Lease liabilities	\$ -	\$ 1,440

See accompanying notes.

# First Sound Bank

## Notes to Financial Statements

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### Note 1 – Nature of Operations and Summary of Significant Accounting Policies

**Nature of operations** – First Sound Bank (the Bank) operates a single branch in downtown Seattle, Washington. The Bank provides loan and deposit services to customers who are predominately small and mid-sized businesses and middle-income individuals in western Washington. The Bank provided small commercial equipment financing agreements (EFA) to businesses that are located throughout the United States. Beginning in December 2017, the Bank ceased their EFA lending program, and have not originated any new EFAs since that date.

**Use of estimates** – The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry. Preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information. Actual results could differ from those estimates. Material estimates that are particularly susceptible to change in the near term relate to the determination of the allowance for loan losses.

All dollar amounts are stated in thousands, except share and share per-share amounts.

**Subsequent events** – Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. The Bank recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Bank's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before the financial statements are available to be issued.

The Bank has evaluated subsequent events through April 29, 2022, which is the date the financial statements are issued.

On November 14, 2021, the Bank entered into an Agreement and Plan of Reorganization and Merger with BM Technologies, Inc (BMT). The agreement states that BMT will merge with and into the Bank with the Bank being the surviving entity. The transaction is subject to regulatory approvals but is expected to close during 2022.

**Cash and cash equivalents** – For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold, all with maturities of 90 days or less. Generally, federal funds are purchased and sold for one-day periods. Investments in federal funds sold are made with major banks as approved by the board of directors. As of December 31, 2021 and 2020, the Federal Reserve Board (FRB) regulations no longer require banks to maintain reserves in the form of cash on hand and deposit balances with the FRB.

**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. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax.

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

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

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the statements of income, and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the write-down is recorded as a realized loss in noninterest income in the statements of income.

To determine OTTI for purchased beneficial interests that, on the purchase date, were not highly rated, the Bank compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

**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).

**Loans and allowance for credit losses** – Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balances and adjusted for any charge-offs, the allowance for credit losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method.

Interest income on loans is accrued daily over the term of the loans based on the principal outstanding. The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, as well as when required by regulatory provision. Past-due status is based on contractual terms of loans. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower has the ability to make contractual interest and principal payments, in which case the loan is returned to accrual status.

# First Sound Bank

## Notes to Financial Statements

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

Most of the Bank's business activity is with customers located in the state of Washington. At December 31, 2021 and 2020, the Bank has \$54,122 and \$41,342, respectively, in loans in commercial real estate and construction, which represented 45% and 33%, respectively, of the Bank's loan portfolio. A loan to any single borrower or a group of related borrowers is generally limited, by federal and state banking regulations, to 20% of the Bank's shareholders' equity, excluding accumulated other comprehensive income.

The Bank's EFA portfolio consists of small ticket equipment financing for term credit. The EFAs differ from direct financing lease contracts only in terms of legal ownership. They are a financing agreement only; ownership resides with the borrower.

The allowance for credit losses is maintained at a level sufficient to provide for probable credit losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided based upon management's continuing analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectability may not be ensured. The detailed analysis includes techniques to estimate the fair value of loan 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 that are classified as impaired. For such loans classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. 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.

When available information confirms that specific loans or portions thereof are uncollectible, identified amounts are charged against the allowance for credit losses. The existence of some or all of the following criteria will generally confirm that a loss has been incurred: the loan is significantly delinquent and the borrower has not demonstrated the ability or intent to bring the loan current; the Bank has no recourse to the borrower, or if it does, the borrower has insufficient assets to pay the debt; and/or the estimated fair value of the loan collateral is significantly below the current loan balance, and there is little or no near-term prospect for improvement.

A loan is considered impaired when the loan is 90 days past due or it is probable that a creditor will be unable to collect all amounts (principal and interest) due according to the contractual terms of the agreement. Smaller balance homogeneous loans, such as residential lines and consumer loans, are collectively evaluated for potential loss. When a loan has been identified as impaired, the amount of the impairment is measured by using discounted cash flows, except when, as a practical expedient, the current fair value of the collateral, reduced by costs to sell, is used. When the measurement of the impaired loan is less than the recorded investment in the loan (including accrued interest), impairment is recognized by creating or adjusting an allocation of the allowance for credit losses.

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

A provision for credit losses is charged against income and added to the allowance for credit losses based on regular assessments of the loan portfolio.

The allowance for credit losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications, and actual loss experience of the loan portfolio. Although management has allocated the allowance for credit losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

A troubled debt restructuring (TDR) is a loan for which the Bank, for reasons related to the borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider. TDRs are individually evaluated for impairment and included in the separately identified impairment disclosures. TDRs are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a TDR is considered to be a collateral-dependent loan, the loan is reported, net, at the fair value of the collateral. For TDRs that subsequently default, the Bank determines the amount of allowance on that loan in accordance with the accounting policy for the allowance for loan losses on loans individually identified as impaired. The Bank incorporates recent historical experience related to TDRs including the performance of TDRs that subsequently default into the calculation of the allowance by loan portfolio segment.

The ultimate recovery of all loans is susceptible to future market factors beyond the Bank's control. These factors may result in losses or recoveries differing significantly from those provided in the financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for credit losses and may require the Bank to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

**Loans held for sale** – Loans held for sale consist of the guaranteed portion of Small Business Administration (SBA) loans the Bank intends to sell after origination and are reflected at the lower of aggregate cost or fair value. Loans are sold with servicing of the sold portion retained by the Bank. When the sale of the loan occurs, the premium received is combined with the estimated present value of future cash flows on the related servicing asset and recorded as a gain on sale of loans in noninterest income. There were no loans held for sale at December 31, 2021 or 2020.

**SBA servicing assets** – The Bank accounts for SBA servicing rights as separately recognized servicing rights and initially measures them at fair value. Fair value is based on market prices for comparable servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The Bank subsequently measures each SBA servicing asset using the amortization method. Under the amortization method, servicing assets are amortized into noninterest income in proportion to, and over the period of, estimated net servicing income. The amortized assets are assessed for impairment or increased obligation, at the loan level, based on the fair value at each reporting date. As of December 31, 2021 and 2020, SBA servicing assets are not considered material and totaled \$147 and \$62, respectively, included in other assets on the balance sheets, from servicing \$10.2 million and \$6.6 million in loans, respectively.

# First Sound Bank

## Notes to Financial Statements

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

**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.

**Intangible assets** – Intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exist that indicate that a goodwill impairment test should be performed. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. There are no assets with indefinite lives on the balance sheets. Other intangible assets consist of a core deposit intangible. Amortization of the core deposit intangible is included in other noninterest expense. The gross carrying amount of the core deposit intangible equaled \$28 and \$38 for the years ended December 31, 2021 and 2020, respectively. Accumulated amortization totaled \$80 and \$70, with amortization expense of \$10, for the years ended December 31, 2021 and 2020, respectively. The remaining balance will be amortized on an accelerated basis through 2025.

**Foreclosed assets** – Foreclosed assets acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the fair value of the properties less estimated costs of disposal, establishing a new cost basis. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values. Any subsequent reductions in carrying values, and revenue and expense from the operations of properties, are charged to operations.

**Premises and equipment** – 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. Leasehold improvements are amortized over the term of the lease or the estimated useful life of the improvement, whichever is less. Asset lives range from 3 to 10 years. Gains or losses on dispositions are reflected in earnings. Assets are reviewed for impairment when events indicate their carrying value may not be recoverable. If management determines impairment exists, the asset is reduced with an offsetting charge to expense.

**Advertising costs** – Advertising costs are expensed as incurred. The amounts are not material to the financial statements.

**Leases** – The Bank accounts for leases in accordance with ASU No. 2016-02, *Leases* (Topic 842). Topic 842 requires lessees to recognize on the balance sheet the assets and liabilities arising from operating leases. A lessee should recognize a liability to make lease payments and a right-of-use (ROU) asset representing its right to use the underlying asset for the lease term. A lessee should include payments to be made in an optional period only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. For operating leases, the lease cost should be allocated over the lease term on a generally straight-line basis.

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

The Bank has elected the short-term lease recognition exemption for certain leases that are less than 12 months in duration or month-to-month. This means, for those leases that qualify, ROU assets or lease liabilities will not be recognized. At December 31, 2021 and 2020, the right of use asset was \$970 and \$1,288, respectively, included within other assets on the balance sheet. At December 31, 2021 and 2020, the lease liability was \$1,144 and \$1,440, respectively, included within other liabilities on the balance sheet. Refer to Note 7 – Leases for further discussion.

**Income taxes** – The Bank records its provision for income taxes under the liability method. Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred taxes result from temporary differences in the recognition of certain income and expense amounts between the Bank's financial statements and its tax return. The principal items giving rise to these differences include net operating losses, valuation adjustments on foreclosed properties, and allowance for credit losses. Because of unused net operating losses, the Bank has not recognized a tax provision. The Bank's policy is to recognize interest and penalties associated with income tax matters in income tax expense.

**Stock-based compensation** – Compensation cost is recognized for stock options and restricted stock awards and is measured at the fair value of these awards on their date of grant. A Black-Scholes model is used to estimate the fair value of stock options, whereas the market price of the Bank's common stock at the date of grant is used to estimate the fair value of restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period for stock option awards and as the restriction period for restricted stock awards. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

**Earnings per common share** – Basic earnings per common share is computed by dividing net income available to common shareholders, which consists of net income less dividends declared, by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share is computed similar to basic earnings per common share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued.

**Fair value of financial instruments** – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, 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.

**Business segments** – Substantially all of the Bank's operations involve the delivery of loan and deposit products to customers. Management makes operating decisions and assesses performance based on an ongoing review of the community banking operation, which constitutes the Bank's only operating segment for financial reporting purposes.

# First Sound Bank

## Notes to Financial Statements

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### Note 2 – Earnings Per Common Share

Earnings per common share at December 31:

	<u>2021</u>	<u>2020</u>
Net income (loss) available to common shareholders	<u>\$ 2,343</u>	<u>\$ (206)</u>
Basic weighted-average common shares outstanding	3,154,586	3,154,586
Plus common stock options considered outstanding for dilutive purposes (excludes antidilutive options)	<u>7,455</u>	<u>-</u>
Diluted weighted-average common shares outstanding	<u>3,162,041</u>	<u>3,154,586</u>
Basic earnings per share	<u>\$ 0.74</u>	<u>\$ (0.07)</u>
Diluted earnings per share	<u>\$ 0.74</u>	<u>\$ (0.07)</u>
Antidilutive shares	<u>10,000</u>	<u>95,000</u>

### Note 3 – Investment Securities Available for Sale

Investment securities available for sale have been classified according to management's intent. Amortized cost of securities and their approximate fair value are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b>December 31, 2021</b>				
Investment securities available for sale				
GNMA mortgage-backed securities	\$ 1,383	\$ 3	\$ (21)	\$ 1,365
Foreign debt	1,000	-	(39)	961
Corporate bonds	4,000	-	(226)	3,774
Collateralized mortgage obligations	979	-	(33)	946
Collateralized mortgage-backed securities	<u>2,931</u>	<u>-</u>	<u>(85)</u>	<u>2,846</u>
	<u>\$ 10,293</u>	<u>\$ 3</u>	<u>\$ (404)</u>	<u>\$ 9,892</u>
<b>December 31, 2020</b>				
Investment securities available for sale				
GNMA mortgage-backed securities	\$ 3,271	\$ 10	\$ (6)	\$ 3,275
Foreign debt	1,000	-	(6)	994
Corporate bonds	<u>4,000</u>	<u>-</u>	<u>(35)</u>	<u>3,965</u>
	<u>\$ 8,271</u>	<u>\$ 10</u>	<u>\$ (47)</u>	<u>\$ 8,234</u>



**First Sound Bank**  
**Notes to Financial Statements**

**Note 3 – Investment Securities Available for Sale (continued)**

Gross unrealized losses on investment securities available for sale and the estimated fair value of the related securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows as of December 31:

	Less Than 12 Months		12 Months or More		Total	
	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value
<b>2021</b>						
Investment securities available for sale						
GNMA mortgage-backed	\$ (10)	\$ 817	\$ (11)	\$ 444	\$ (21)	\$ 1,261
Foreign debt	-	-	(39)	961	(39)	961
Corporate bonds	-	-	(226)	3,774	(226)	3,774
Collateralized mortgage obligations	(33)	946	-	-	(33)	946
Collateralized mortgage-backed securities	(85)	2,846	-	-	(85)	2,846
	<u>\$ (128)</u>	<u>\$ 4,609</u>	<u>\$ (276)</u>	<u>\$ 5,179</u>	<u>\$ (404)</u>	<u>\$ 9,788</u>
<b>2020</b>						
Investment securities available for sale						
GNMA mortgage-backed	\$ (6)	\$ 1,113	\$ -	\$ -	\$ (6)	\$ 1,113
Corporate bonds	(35)	3,965	-	-	(35)	3,965
Foreign debt	(6)	994	-	-	(6)	994
	<u>\$ (47)</u>	<u>\$ 6,072</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (47)</u>	<u>\$ 6,072</u>

The Bank had six and four investment securities with gross unrealized losses at December 31, 2021 and 2020, respectively. Unrealized losses have not been recognized into income because management does not intend to sell and does not expect it will be required to sell the investment. The unrealized losses are largely due to changes in market conditions and interest rates, rather than credit quality. The fair value is expected to recover as the underlying security in the portfolio approaches maturity date and market conditions improve. The Bank does not consider these securities to be other than temporarily impaired at December 31, 2021 or 2020.

During the year ended December 31, 2021, the Bank did not sell any securities. During the year ended December 31, 2020, the Bank sold one security for no gain or loss.

# First Sound Bank

## Notes to Financial Statements

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### Note 3 – Investment Securities Available for Sale (continued)

The amortized cost and estimated fair value of securities at December 31, 2021, 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.

	Amortized Cost	Fair Value
Due in 1 year or less	\$ -	\$ -
Due in 1 to 5 years	2,101	2,025
Due in over 5 years	8,192	7,867
	<u>\$ 10,293</u>	<u>\$ 9,892</u>

Securities carried at approximately \$9,892 and \$8,234 were pledged to the FRB at December 31, 2021 and 2020, respectively, for other purposes required or permitted by law.

### Note 4 – Loans and Allowance for Credit Losses

Loans at December 31 consist of the following:

	2021	2020
Commercial	\$ 27,694	\$ 43,186
Real estate		
Commercial	51,123	40,637
Residential	30,744	28,648
Construction	2,999	705
Equipment finance	907	4,411
Consumer	707	2,237
Government guaranteed	5,022	5,586
	<u>119,196</u>	<u>125,410</u>
Premium on purchased loans	19	61
Deferred loan origination fees, net	(19)	(105)
	<u>\$ 119,196</u>	<u>\$ 125,366</u>

Certain related parties of the Bank, principally Bank directors and their associates, were loan customers of the Bank in the ordinary course of business during 2021 and 2020. During the year ended December 31, 2021, the Bank experienced \$33 in additions and \$49 in pay-downs and loans removed for no longer related party classification, with an ending balance of \$2,230. During the year ended December 31, 2020, the Bank experienced \$0 in additions and \$48 in pay-downs and loans removed for no longer related party classification, with an ending balance of \$2,246.

## First Sound Bank Notes to Financial Statements

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

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed by the President of the United States. During the years ended December 31, 2021 and 2020, the Bank participated in the Paycheck Protection Program (PPP), under the CARES Act, whereby loans to small businesses are made and those loans are subject to the regulatory requirements that would require forbearance of loan payments for a specified time or that would limit the ability to pursue all available remedies in the event of a loan default. The above table includes \$9,858 and \$29,883 of PPP loans administered by the U.S. Small Business Administration (SBA) within the commercial loan segment as of December 31, 2021 and 2020, respectively.

Loans of approximately \$41,767 and \$32,690 at December 31, 2021 and 2020, respectively, were pledged to secure the available borrowings with the FHLB. PPP loans of approximately \$8,708 and \$26,871 at December 31, 2021 and 2020, respectively, were pledged to secure loans with the FRB.

The following table presents the activity in the allowance for credit losses by segment for the years ended December 31, 2021 and 2020:

	Beginning Balance	Provision (Benefit) for Loan Losses	Charge-offs	Recoveries	Ending Balance
<b>2021</b>					
Commercial	\$ 246	\$ 49	\$ -	\$ -	\$ 295
Real estate					
Commercial	533	108	-	-	641
Residential	71	3	-	-	74
Construction	10	32	-	-	42
Equipment finance	83	(79)	(25)	38	17
Consumer	33	(26)	-	-	7
Government guaranteed	-	-	-	-	-
Unallocated	431	(16)	-	-	416
	<u>\$ 1,407</u>	<u>\$ 71</u>	<u>\$ (25)</u>	<u>\$ 38</u>	<u>\$ 1,492</u>
<b>2020</b>					
Commercial	\$ 167	\$ 79	\$ -	\$ -	\$ 246
Real estate					
Commercial	419	89	-	25	533
Residential	53	18	-	-	71
Construction	5	5	-	-	10
Equipment finance	151	35	(145)	42	83
Consumer	56	(23)	-	-	33
Government guaranteed	-	-	-	-	-
Unallocated	634	(203)	-	-	431
	<u>\$ 1,485</u>	<u>\$ -</u>	<u>\$ (145)</u>	<u>\$ 67</u>	<u>\$ 1,407</u>

# First Sound Bank

## Notes to Financial Statements

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

The allowance for credit losses and recorded investment in loans receivable as of December 31 are as follows:

	Allowance for Credit Losses			Loans		
	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
<b>2021</b>						
Commercial	\$ 295	\$ -	\$ 295	\$ 27,694	\$ 680	\$ 27,014
Real estate						
Commercial	641	-	641	51,123	845	50,278
Residential	74	-	74	30,744	-	30,744
Construction	42	-	42	2,999	-	2,999
Equipment finance	17	-	17	907	28	879
Consumer	7	-	7	707	-	707
Government guaranteed	-	-	-	5,022	-	5,022
Unallocated	416	-	416	-	-	-
	<u>\$ 1,492</u>	<u>\$ -</u>	<u>\$ 1,492</u>	<u>\$ 119,196</u>	<u>\$ 1,553</u>	<u>\$ 117,643</u>
<b>2020</b>						
Commercial	\$ 246	\$ -	\$ 246	\$ 43,186	\$ -	\$ 43,186
Real estate						
Commercial	533	-	533	40,637	1,663	38,974
Residential	71	-	71	28,648	843	27,805
Construction	10	-	10	705	-	705
Equipment finance	83	-	83	4,411	-	4,411
Consumer	33	-	33	2,237	-	2,237
Government guaranteed	-	-	-	5,586	-	5,586
Unallocated	431	-	431	-	-	-
	<u>\$ 1,407</u>	<u>\$ -</u>	<u>\$ 1,407</u>	<u>\$ 125,410</u>	<u>\$ 2,506</u>	<u>\$ 122,904</u>

**Credit quality indicator** – Federal regulations provide for the classification of lower quality loans and other assets, such as debt and equity securities, as substandard, doubtful, or loss. An asset is considered substandard if it is inadequately protected by the current net worth and pay capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses inherent in those classified as 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. The grade for special mention is assigned to loans that have been criticized based upon known characteristics such as periodic payment delinquency or deteriorating financial condition of the borrower and/or guarantors.

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

EFAs are classified by the Bank, depending on the payment status of the borrower. Pass EFAs are listed as current and are reserved for based on a calculated rate using gross charge-off data from prior periods, adjusted for qualitative factors. Impaired EFAs classified as doubtful are not individually evaluated for impairment; rather, they are treated as a homogeneous pool for reserving purposes.

When the Bank classifies problem assets as either special mention, substandard, or doubtful pursuant to federal regulations, it may establish a specific allowance in an amount it deems prudent and approved by management and the board to address the risk specifically, or it 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 that, unlike specific allowances, have not been specifically allocated to the particular problem assets. When an insured institution classifies problem assets as a loss, pursuant to federal regulations, it is required to charge off such assets in the period in which they are deemed uncollectible. The Bank's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Federal Deposit Insurance Corporation (FDIC) and the Washington State Department of Financial Institutions, both of which can require the establishment of additional loss allowances.

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

The following tables show credit quality indicators as of December 31:

Credit risk profile by internally assigned grade

<b>December 31, 2021</b>	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 26,786	\$ 190	\$ 718	\$ -	\$ 27,694
Real estate					
Commercial	50,278	-	845	-	51,123
Residential	30,744	-	-	-	30,744
Construction	2,999	-	-	-	2,999
Equipment finance	907	-	-	-	907
Consumer	707	-	-	-	707
Government guaranteed	5,022	-	-	-	5,022
	<u>\$ 117,443</u>	<u>\$ 190</u>	<u>\$ 1,563</u>	<u>\$ -</u>	<u>\$ 119,196</u>
<b>December 31, 2020</b>					
Commercial	\$ 41,494	\$ 197	\$ 1,495	\$ -	\$ 43,186
Real estate					
Commercial	38,974	-	1,663	-	40,637
Residential	27,805	-	843	-	28,648
Construction	705	-	-	-	705
Equipment finance	4,411	-	-	-	4,411
Consumer	2,237	-	-	-	2,237
Government guaranteed	5,586	-	-	-	5,586
	<u>\$ 121,212</u>	<u>\$ 197</u>	<u>\$ 4,001</u>	<u>\$ -</u>	<u>\$ 125,410</u>

# First Sound Bank

## Notes to Financial Statements

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

The following table shows the age analysis of past due loans receivable as of December 31:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More	Total Past Due	Current	Total Loans and Leases	Recorded Investment > 90 Days and Accruing
<b>December 31, 2021</b>							
Commercial	\$ -	\$ -	\$ 680	\$ 680	\$ 27,014	\$ 27,694	\$ -
Real estate							
Commercial	-	-	845	845	50,278	51,123	-
Residential	5,767	-	-	5,767	24,977	30,744	-
Construction	-	-	-	-	2,999	2,999	-
Equipment finance	-	-	28	28	879	907	-
Consumer	-	-	-	-	707	707	-
Government guaranteed	-	-	-	-	5,022	5,022	-
	<u>\$ 5,767</u>	<u>\$ -</u>	<u>\$ 1,553</u>	<u>\$ 7,320</u>	<u>\$ 111,876</u>	<u>\$ 119,196</u>	<u>\$ -</u>
<b>December 31, 2020</b>							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 43,186	\$ 43,186	\$ -
Real estate							
Commercial	-	-	1,663	1,663	38,974	40,637	-
Residential	155	-	843	998	27,650	28,648	-
Construction	-	-	-	-	705	705	-
Equipment finance	26	163	-	189	4,222	4,411	-
Consumer	-	-	-	-	2,237	2,237	-
Government guaranteed	-	-	150	150	5,436	5,586	150
	<u>\$ 181</u>	<u>\$ 163</u>	<u>\$ 2,656</u>	<u>\$ 3,000</u>	<u>\$ 122,410</u>	<u>\$ 125,410</u>	<u>\$ 150</u>

**First Sound Bank**  
**Notes to Financial Statements**

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

The following table shows impaired loans at December 31:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>December 31, 2021</b>					
With related allowance recorded					
Equipment finance	\$ -	\$ -	\$ -	\$ -	\$ -
With no allowance recorded					
Commercial	680	680	-	340	-
Commercial real estate	845	845	-	1,254	-
Residential real estate	-	-	-	422	-
Equipment finance	28	28	-	14	-
Total					
Commercial	680	680	-	340	-
Commercial real estate	845	845	-	1,254	-
Residential real estate	-	-	-	422	-
Equipment finance	28	28	-	14	-
<b>December 31, 2020</b>					
With related allowance recorded					
Equipment finance	\$ -	\$ -	\$ -	\$ 48	\$ -
With no allowance recorded					
Commercial real estate	1,663	1,663	-	1,732	-
Residential real estate	843	843	-	422	-
Total					
Commercial real estate	1,663	1,663	-	1,732	-
Residential real estate	843	843	-	422	-
Equipment finance	-	-	-	48	-

The following table shows loans receivable on nonaccrual status as of December 31:

	2021	2020
Commercial real estate	\$ 845	\$ 1,663
Commercial	680	-
Residential real estate	-	843
Equipment finance	28	-
	<u>\$ 1,553</u>	<u>\$ 2,506</u>

There were no loans classified as troubled debt restructurings for the years ended December 31, 2021 and 2020.

# First Sound Bank

## Notes to Financial Statements

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

Section 4013 of the CARES Act and Section 541 of the Coronavirus Response and Relief Supplemental Appropriations Act of 2021 (the Coronavirus Relief Act) passed in January 2021 provided additional optional, temporary relief from evaluating loans that may have been considered TDRs under GAAP. This relief applies to loan modifications executed between March 1, 2020, and the earlier of 60 days after the national emergency related to the Pandemic is terminated, or January 1, 2022. The Bank elected to apply these temporary accounting provisions to payment relief loans beginning in March 2020. As of December 31, 2021, there were no loans modified as CARES Act deferrals and not subject to TDR accounting. At December 31, 2020, 40 loans totaling \$7.5 million were modified as CARES Act deferrals and not subject to TDR accounting and related reporting, with all loans but one, totaling \$60,000, returning to current payment status.

### Note 5 – Premises and Equipment

Components of premises and equipment as of December 31:

	<u>2021</u>	<u>2020</u>
Leasehold improvements	\$ 620	\$ 620
Furniture and equipment	<u>1,162</u>	<u>1,145</u>
	1,782	1,765
Less accumulated depreciation and amortization	<u>(1,680)</u>	<u>(1,628)</u>
Premises and equipment, net	<u>\$ 102</u>	<u>\$ 137</u>

Depreciation and amortization expense totaled \$50 and \$55 for the years ended December 31, 2021 and 2020, respectively.

### Note 6 – Leases

The Bank leases its premises under an operating lease that expires on November 30, 2024, and contains an escalation clause based on increases in property taxes and other costs.

The components of lease cost (included in occupancy and equipment expense on the statements of income (loss)) are as follows for the year ended December 31:

	<u>2021</u>	<u>2020</u>
Lease cost		
Minimum rent payments	\$ 322	\$ 306
Other operating costs	<u>206</u>	<u>205</u>
	<u>\$ 528</u>	<u>\$ 511</u>



**First Sound Bank**  
**Notes to Financial Statements**

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**Note 6 – Leases (continued)**

The following table provides supplemental information related to operating leases for the purpose of the measurement of lease liabilities as of or for the year ended December 31:

	<u>2021</u>	<u>2020</u>
Operating cash flows from operating leases	\$ 322	\$ 306
Weighted average remaining lease term (years)	2.92	3.92
Weighted average discount rate	1.98%	1.98%

Rental expense under operating leases was \$528 and \$511 for the years ended December 31, 2021 and 2020, respectively. Minimum rental commitments under noncancelable leases having an original or remaining term of more than one year for future years ending December 31 are as follows:

2022	\$ 393
2023	404
2024	<u>381</u>
Total lease payments	1,178
Less imputed interest	<u>(34)</u>
Total	<u>\$ 1,144</u>

The Bank's lease does not contain a discount rate implicit in the lease contract. As an alternative, the Bank uses the incremental borrowing rate commensurate with the lease term.

**Note 7 – Foreclosed Assets**

The following table presents foreclosed assets as of December 31:

	<u>2021</u>	<u>2020</u>
Beginning balance	\$ -	\$ 1,769
Sales	-	(1,207)
Gain (loss) on sales	-	(2)
Write-downs	-	<u>(560)</u>
Ending balance	<u>\$ -</u>	<u>\$ -</u>

Foreclosed assets include undeveloped land at December 31, 2021 and 2020.

# First Sound Bank

## Notes to Financial Statements

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### Note 8 – Deposits

The composition of deposits at December 31 is as follows:

	<u>2021</u>	<u>2020</u>
Demand deposits, noninterest-bearing	\$ 33,983	\$ 32,505
Savings and interest-bearing demand	70,174	66,395
Time certificates	<u>5,178</u>	<u>7,198</u>
	<u>\$ 109,335</u>	<u>\$ 106,098</u>

Time certificates maturing in years ending December 31 are as follows:

2022	\$ 3,985
2023	474
2024	574
2025	-
2026	<u>145</u>
	<u>\$ 5,178</u>

As of December 31, 2021 and 2020, there were \$1,293 and \$2,241, respectively, of time certificates that met or exceeded the \$250 FDIC-insured limits.

As of December 31, 2021 and 2020, there were no brokered deposits outstanding.

Related party deposits totaled \$3,030, and \$2,270 at December 31, 2021 and 2020, respectively.

### Note 9 – Borrowings

The Bank has a credit line with the FHLB of Des Moines totaling 21% of the Bank's assets, dependent on sufficient collateral at the time of borrowing and FHLB stock ownership. At December 31, 2021 and 2020, \$30,018 and \$22,452, respectively, was available. At December 31, 2021 and 2020, there were outstanding borrowings of \$5,000 and \$1,500, respectively, bearing interest at 0.30%.

The Bank has a credit line with the FRB for which the amount is based on collateral pledged, subject to interest at the then-current rate. At December 31, 2021 and 2020, \$251 and \$1,117, respectively, was available. At December 31, 2021 and 2020, there were no outstanding borrowings on this line.

The Bank also has line-of-credit agreements with unaffiliated banks totaling \$13 million. These lines provide for lending at the bank's federal fund rates. There were no borrowings outstanding on these lines at December 31, 2021 and 2020.

**Note 9 – Borrowings (continued)**

The Bank also utilized the Federal Reserve Bank's Paycheck Protection Program Liquidity Facility (the PPPLF) to fund PPP loans during the year ended December 31, 2021. These advances had an interest rate of 0.35%. The Bank has not obtained any other new borrowing lines or other new sources of liquidity other than the PPPLF program during the years ended December 31, 2021 and 2020. The Bank had \$8,708 and \$26,871 outstanding in PPPLF as of December 31, 2021 and 2020, respectively, which matures in April 2026, and has pledged with loans as required by the terms of the PPPLF.

**Note 10 – Employee Benefits**

The Bank has a combined 401(k) and profit-sharing plan covering substantially all employees. Contributions to the Bank's 401(k) and profit sharing plan consist of a 3% safe harbor nonelective contribution and profit sharing contributions, which are both at the discretion of its board of directors. The Bank made safe harbor elections of \$63 and \$58 for the years ended December 31, 2021 and 2020, respectively.

# First Sound Bank

## Notes to Financial Statements

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### Note 11 – Income Taxes

For the year ended December 31, 2021, the Bank recorded current tax expense of \$0 and deferred tax benefit of \$1,794. The effective tax rate differs from the statutory rate of 21% mainly due to the reversal of valuation allowance. For the year ended December 31, 2020, no tax provision was recorded.

Tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities at December 31 are as follows:

	<u>2021</u>	<u>2020</u>
Deferred tax assets		
Operating loss carryforward	\$ 1,926	\$ 1,917
Intangibles	155	279
Other, net	44	48
Fixed asset basis	102	107
Lease liability	<u>240</u>	<u>302</u>
Total deferred tax assets	<u>2,467</u>	<u>2,653</u>
Deferred tax liabilities		
Loan origination costs	85	64
Allowance for credit losses	384	399
Right of use asset	<u>204</u>	<u>270</u>
Total deferred tax liabilities	<u>673</u>	<u>733</u>
Net deferred tax assets before valuation allowance	1,794	1,920
Valuation allowance	<u>-</u>	<u>(1,920)</u>
Net deferred tax assets	<u>\$ 1,794</u>	<u>\$ -</u>

Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of net operating loss and credit carryforwards may be limited in the event a cumulative change in ownership of more than 50 percent occurs within a three-year period. The Bank determined that such ownership changes occurred as of July 9, 2010, and February 20, 2013. This ownership change resulted in limitations on the use of net operating loss carryforwards, including the inability to use approximately \$40.4 million of the federal net operating loss carryforward. Pursuant to Section 382, a portion of the limited net operating loss carryforwards becomes available for use each year. Approximately \$170 thousand of the restricted net operating loss carryforwards will become available each year. Additionally, net operating losses acquired from a 2015 merger are subject to Section 382 annual limitations in the amount of approximately \$11 thousand per year.

Management recorded a valuation allowance against deferred tax assets for the year ended December 31, 2020. The Bank reversed the valuation allowance during the year ended December 31, 2021 after concluding that the deferred tax assets are more likely than not to be realized. The Bank considered income in prior periods, projected future income, and projected future reversals of deferred tax items in making this determination.

**Note 11 – Income Taxes (continued)**

Prior to the impact of the Section 382 limitations, the Bank has federal net operating loss carryforwards of approximately \$56.1 million at December 31, 2021. As a result of Section 382 limitations, total usable federal operating loss carryforwards total \$9.1 million. Federal net operating loss carryforwards generated prior to December 31, 2017, to the extent not used, will begin to expire in 2028. Federal net operating loss carryforwards generated after December 31, 2017, which do not expire, totaled approximately \$2.0 million as of December 31, 2021.

At December 31, 2021 and 2020, the Bank had no unrecognized tax benefits. The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2021 and 2020, the Bank recognized no interest and penalties. The Bank files income tax returns in the U.S. federal jurisdiction. The Bank is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2018.

**Note 12 – Commitments and Contingencies**

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the balance sheets.

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

A summary of the Bank's commitments at December 31 is as follows:

	2021	2020
Commitments to extend credit		
Real estate secured	\$ 8,735	\$ 8,004
Commercial lines of credit	16,118	16,213
Total commitments to extend credit	\$ 24,853	\$ 24,217

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. 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 60% of loan commitments are drawn upon by customers. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

# First Sound Bank

## Notes to Financial Statements

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### Note 13 – Stock Compensation Plans

In May 2013, the Bank adopted the 2013 Long-Term Equity Incentive Plan (the Equity Plan). The Equity Plan permits the grant of nonqualified stock options, incentive stock options, restricted stock, and restricted stock unit awards. The Equity Plan authorizes 203,000 shares for grant, subject to no more than 40,600 shares being issued as restricted stock grants or restricted stock unit awards. The Bank has 414 options/shares remaining to grant as of December 31, 2021.

The restricted stock grants are valued at fair market value at date of grant. The restricted stock grants vest over a period of three years, and expense is recognized using the straight-line method.

The Bank uses the Black-Scholes option valuation model to determine the weighted-average fair value of options. The Bank uses assumptions on expected life, risk-free rate, expected volatility, and dividend yield to determine such values. The expected life of options is derived using the simplified method. The risk-free rate is based on Treasury instruments in effect on the date of grant whose terms are consistent with the expected life of the Bank's stock options. Expected volatility is based on historical volatility of the Bank's stock. The dividend yield is based on historical experience and expected future changes. The Bank has not historically paid dividends on its common stock.

A summary of the status of the Bank's stock option plan activity for the year ended December 31, 2021, is presented below:

	Shares Underlying Options	Weighted- Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Remaining Contractual Life (Years)
Options outstanding, December 31, 2020	95,000	\$ 5.27	\$ -	
Granted	-	-	-	
Exercised	-	-	-	
Expired/forfeited	-	-	-	
	<u>95,000</u>	<u>\$ 5.27</u>	<u>\$ 145,200</u>	2.42
Options exercisable, December 31, 2021	<u>91,000</u>	<u>\$ 5.32</u>	<u>\$ 134,640</u>	2.04

As of December 31, 2021, unrecognized compensation expense related to granted shares was not considered material.

**Note 14 – Regulatory Matters**

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 of the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy 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 classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

On September 17, 2019, the Regulatory Agencies issued a new rule to provide for a simplified measure of capital adequacy for certain community banking organizations, consistent with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act. The community bank leverage ratio (CBLR) framework took effect on January 1, 2020, and allows qualifying community banking organizations to calculate a leverage ratio to measure capital adequacy. Banks opting into the CBLR framework are not required to calculate or report risk-based capital. The Bank elected the CBLR framework effective January 1, 2020.

A qualifying community banking organization is defined as having less than \$10 billion in total consolidated assets, leverage ratio greater than 9%, off-balance-sheet exposures of 25% or less of total consolidated assets, and trading assets and liabilities of 5% or less of total consolidated assets. As of December 31, 2021, the Bank has satisfied the CBLR qualifying criteria, is deemed to have met the well capitalized ratio requirements, and is in compliance with the generally applicable capital rule. In April 2020, the CARES Act reduced on a temporary basis the CBLR ratio to 8%. The regulatory agencies further issued two interim rules to adopt the CARES Act provision and to provide a transition from the temporary rule to a 9% CBLR requirement. The second interim rule provides that the CBLR will be 8% in year 2020, increase to 8.5% on January 1, 2021, and then to 9% on January 1, 2022, and thereafter. If the Bank’s CBLR ratio falls below the minimum requirement, the Bank has a two-quarter grace period to get back into compliance. The Bank may opt out of the CBLR framework at any time, without restriction, by reverting to the generally applicable risk-based capital rule. Management believes that as of December 31, 2021, the Bank meets all capital adequacy requirements to which it is subject.

The Bank’s actual capital amounts and ratios are also presented in the following 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
<b>As of December 31, 2021</b>								
<i>CBLR framework</i>								
CBLR ratio	\$ 14,261	10.33%	\$ 11,732	≥ 8.50%	N/A	N/A	\$ 11,732	≥ 8.50%
<b>As of December 31, 2020</b>								
<i>CBLR framework</i>								
CBLR ratio	\$ 13,339	10.58%	\$ 10,085	≥ 8.00%	N/A	N/A	\$ 10,085	≥ 8.00%

# First Sound Bank

## Notes to Financial Statements

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### Note 15 – Fair Value of Financial Instruments

**Fair value determination** – Fair value is based on quoted market prices, when available, for identical or similar assets or liabilities. In the absence of quoted market prices, management determines the fair value of the Bank's assets and liabilities using valuation models or third-party pricing services, both of which rely on market-based parameters when available, such as interest rate yield curves, option volatilities and credit spreads, or unobservable inputs. Unobservable inputs may be based on management's judgment, assumptions, and estimates related to credit quality, liquidity, interest rates, and other relevant inputs.

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820 establishes a three-level valuation hierarchy for determining fair value that is based on the transparency of the inputs used in the valuation process. The inputs used in determining fair value in each of the three levels of the hierarchy are as follows:

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

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

**Level 3** – Unobservable inputs.

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

**Qualitative disclosures of valuation techniques** – Securities available for sale consist of U.S. government and agency securities and U.S. agency mortgage-backed securities. The Bank reports securities available for sale at fair value on a recurring basis. The fair value of the Bank's securities available for sale is determined using Level 1 inputs, which are derived from quoted prices in active markets, and Level 2 inputs, which are derived from quoted prices for identical or similar assets in markets that are active or not active; that is, markets in which there are a few transactions for the asset, the prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly.



**Note 15 – Fair Value of Financial Instruments (continued)**

**Assets measured at fair value on a recurring basis** – The balance of securities available for sale at December 31, the fair value of which is disclosed on a recurring basis (there were no transfers between Level 1 and Level 2 in 2021 or 2020), is presented below:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>December 31, 2021</b>				
Investment securities available for sale				
GNMA mortgage-backed securities	\$ -	\$ 1,365	\$ -	\$ 1,365
Foreign debt securities	-	961	-	961
Corporate bonds	-	3,774	-	3,774
Collateralized mortgage obligations	-	946	-	946
Collateralized mortgage-backed securities	-	2,846	-	2,846
	<u>\$ -</u>	<u>\$ 9,892</u>	<u>\$ -</u>	<u>\$ 9,892</u>
<b>December 31, 2020</b>				
Investment securities available for sale				
GNMA mortgage-backed securities	\$ -	\$ 3,275	\$ -	\$ 3,275
Foreign debt securities	-	994	-	994
Corporate bonds	-	3,965	-	3,965
	<u>\$ -</u>	<u>\$ 8,234</u>	<u>\$ -</u>	<u>\$ 8,234</u>

**Fair value on a nonrecurring basis** – Certain assets are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). There were no nonrecurring fair value adjustments as of or during the years ended December 31, 2021, and 2020.

# First Sound Bank

## Notes to Financial Statements

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### Note 15 – Fair Value of Financial Instruments (continued)

The estimated fair value of the Bank's financial instruments at December 31 is as follows:

	Carrying Value	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>2021</b>				
Financial assets				
Cash and cash equivalents	\$ 8,323	\$ 8,323	\$ -	\$ -
Securities available for sale	9,892	-	9,892	-
FHLB stock	380	-	380	-
Loans, net	117,704	-	-	116,970
Accrued interest receivable	358	358	-	-
Financial liabilities				
Borrowings	\$ 13,708	\$ -	\$ 13,708	\$ -
Demand deposits	104,157	104,157	-	-
Time deposits	5,178	-	5,166	-
Accrued interest payable	23	23	-	-
<b>2020</b>				
Financial assets				
Cash and cash equivalents	\$ 14,910	\$ 14,910	\$ -	\$ -
Securities available for sale	8,234	-	8,234	-
FHLB stock	188	-	188	-
Loans, net	123,959	-	-	122,524
Accrued interest receivable	502	502	-	-
Financial liabilities				
Borrowings	\$ 28,371	\$ -	\$ 28,371	-
Demand deposits	98,900	98,900	-	-
Time deposits	7,198	-	7,179	-
Accrued interest payable	29	29	-	-

The following methods and assumptions were used by the Bank in estimating the fair value of financial instruments, as disclosed in the financial statements:

*Cash and cash equivalents and interest-bearing deposits in other financial institutions, accrued interest* – The recorded amount is a reasonable estimate of fair value.

*Securities available for sale* – Fair values are based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

*Federal Home Loan Bank stock* – The carrying value of Federal Home Loan Bank stock approximates fair value.

*Loans* – The fair value of loans receivable was calculated from inputs reflective of current market pricing for similar instruments, to include current origination spreads, liquidity premiums, and credit adjustments. The fair value of nonperforming loans is estimated using the fair value of the underlying collateral.

**Note 15 – Fair Value of Financial Instruments (continued)**

*Deposits* – The fair value of deposits with no stated maturity date is included at the amount payable on demand. The fair value of fixed-rate certificates of deposit is estimated using a discounted cash flow calculation based on interest rates currently offered on similar certificates. The carrying amount of variable-rate certificates of deposit approximates fair value at the reporting date.

*Borrowings* – Fixed and variable-term borrowings are valued using a discounted replacement cost of funds approach. Option structures use discounted market price less an appropriate spread to adjust for the option.

*Off-balance-sheet instruments* – The fair value of commitments to extend credit is estimated using fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the customers. Because the majority of the Bank's off-balance-sheet instruments consist of non-fee-producing, variable-rate commitments, the Bank has determined that they do not have a distinguishable fair value.

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair value of the Bank's financial instruments will change when interest rate levels change, and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed-rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

