



REPORT OF INDEPENDENT AUDITORS
AND FINANCIAL STATEMENTS

FIRST SOUND BANK

December 31, 2018 and 2017



MOSSADAMS

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Report of Independent Auditors

To the Board of Directors
First Sound Bank

Report on the Financial Statements

We have audited the accompanying financial statements of First Sound Bank (the Bank), which comprise the balance sheets as of December 31, 2018 and 2017, 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 First Sound Bank as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Everett, Washington
June 13, 2019

First Sound Bank
Balance Sheets (dollars in thousands)

ASSETS

	December 31,	
	2018	2017
Cash and cash equivalents	\$ 27,971	\$ 18,361
Investment securities, available for sale	1,593	955
Federal Home Loan Bank stock, at cost	173	563
Loans	100,987	122,990
Allowance for credit losses	(1,456)	(1,409)
Net loans	99,531	121,581
Premises and equipment, net	182	154
Accrued interest receivable	236	258
Foreclosed assets, net	1,769	1,912
Other assets	448	565
Total assets	\$ 131,903	\$ 144,349

LIABILITIES AND SHAREHOLDERS' EQUITY

LIABILITIES		
Deposits	\$ 117,908	\$ 120,533
Borrowings	-	10,000
Accrued interest payable	25	24
Other liabilities	418	591
Total liabilities	118,351	131,148
SHAREHOLDERS' EQUITY		
Preferred stock (par value \$0.01); 10,000 shares authorized, no shares issued and outstanding in 2018 and 2017	-	-
Common stock (no par value); authorized: 3,250,000 shares in 2018 and 2017; issued and outstanding: 3,154,333 and 3,151,833 shares in 2018 and 2017, respectively	61,340	61,324
Accumulated deficit	(47,771)	(48,114)
Accumulated other comprehensive loss	(17)	(9)
Total shareholders' equity	13,552	13,201
Total liabilities and shareholders' equity	\$ 131,903	\$ 144,349

First Sound Bank

Statements of Income (dollars in thousands)

	Years Ended December 31,	
	2018	2017
INTEREST INCOME		
Interest and fees on loans	\$ 4,902	\$ 5,303
Interest on deposits in other financial institutions	397	153
Interest on investments	28	11
Total interest income	5,327	5,467
INTEREST EXPENSE		
Deposits	808	749
Borrowings	66	40
Total interest expense	874	789
Net interest income before provision for credit losses	4,453	4,678
PROVISION FOR CREDIT LOSSES		
Net interest income after provision for credit losses	4,453	4,472
NONINTEREST INCOME		
Service charge income	157	115
Sublease income	24	208
Gain on sale of loans	150	333
Servicing fees	4	7
Other income	92	651
Total noninterest income	427	1,314
NONINTEREST EXPENSE		
Salaries and benefits	2,175	2,567
Occupancy expenses	615	799
Professional and regulatory expenses	451	443
Data processing	450	479
Impairment on foreclosed assets	-	200
(Gain) loss on sale of foreclosed assets	(34)	-
Insurance expense	164	153
Loan and lease expense	60	48
Other operating expenses	656	788
Total noninterest expense	4,537	5,477
NET INCOME	\$ 343	\$ 309
EARNINGS PER COMMON SHARE		
Basic	\$ 0.11	\$ 0.10
Diluted	\$ 0.11	\$ 0.10
Weighted-average number of common shares outstanding		
Basic	3,152,155	2,965,103
Diluted	3,232,155	3,048,672

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

	Years Ended December 31,	
	<u>2018</u>	<u>2017</u>
NET INCOME	<u>\$ 343</u>	<u>\$ 309</u>
Other comprehensive loss		
Unrealized holding loss on securities available for sale	<u>(8)</u>	<u>(4)</u>
Other comprehensive loss	<u>(8)</u>	<u>(4)</u>
COMPREHENSIVE INCOME	<u>\$ 335</u>	<u>\$ 305</u>

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

	Common Stock		Accumulated Deficit	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Number of Shares	Amount			
BALANCE, December 31, 2016	2,936,735	\$ 60,239	\$ (48,423)	\$ (5)	\$ 11,811
Net income	-	-	309	-	309
Vesting of restricted stock	5,667	-	-	-	-
Stock-based compensation	-	38	-	-	38
Stock issued	209,431	1,047	-	-	1,047
Unrealized loss on securities	-	-	-	(4)	(4)
BALANCE, December 31, 2017	3,151,833	61,324	(48,114)	(9)	13,201
Net income	-	-	343	-	343
Vesting of restricted stock	2,500	-	-	-	-
Stock-based compensation	-	16	-	-	16
Unrealized loss on securities	-	-	-	(8)	(8)
BALANCE, December 31, 2018	<u>3,154,333</u>	<u>\$ 61,340</u>	<u>\$ (47,771)</u>	<u>\$ (17)</u>	<u>\$ 13,552</u>

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

	Years Ended December 31,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 343	\$ 309
Adjustments to reconcile net income to net cash from operating activities		
Provision for credit losses	-	206
Amortization of premiums on investment securities	2	8
Depreciation and amortization	48	51
Gain on sale of loans	(150)	(333)
Gain on sale of foreclosed assets	(34)	-
Write down of foreclosed assets	-	200
Stock-based compensation	16	38
Increase (decrease) in cash due to changes in certain assets and liabilities		
Accrued interest receivable	22	(32)
Other assets	105	260
Other liabilities	(173)	(2,042)
Accrued interest payable	1	4
	<u>180</u>	<u>(1,331)</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of securities available for sale	(1,738)	(300)
Proceeds from paydowns and maturities of securities available for sale	1,090	372
Net change in loans	22,200	(3,752)
Change in Federal Home Loan Bank stock, net	390	36
Proceeds from sale of foreclosed assets	177	273
Additions to premises and equipment, net	(64)	(22)
	<u>22,055</u>	<u>(3,393)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net change in borrowings	(10,000)	(1,200)
Proceeds from issuance of stock	-	1,047
Net change in deposits	(2,625)	10,592
	<u>(12,625)</u>	<u>10,439</u>
Net increase in cash and cash equivalents	9,610	5,715
CASH AND CASH EQUIVALENTS, beginning of year	<u>18,361</u>	<u>12,646</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 27,971</u>	<u>\$ 18,361</u>
SUPPLEMENTAL CASH AND NONCASH DISCLOSURES		
Cash paid during the year for interest	\$ 870	\$ 785
Unrealized loss on securities	\$ (8)	\$ (4)

First Sound Bank

Notes to Financial Statements

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 midsized businesses and middle-income individuals in western Washington. The Bank also provided small commercial equipment financing agreements (EFA) to businesses that are located throughout the United States. Beginning in December 2017, the Bank ceased the EFA lending program.

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, the valuation of other real estate owned, and the valuation allowance on the deferred tax asset.

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 June 13, 2019, which is the date the financial statements are issued.

On May 15, 2019, the Bank's board of directors approved a 100 for 1 reverse stock split on its shares of common stock. Unless otherwise noted, impacted amounts and share information included in the financial statements and notes thereto have been retroactively adjusted for the stock split as if such stock split occurred on the first day of the first period presented. Certain amounts in the notes to the financial statements may be slightly different than previously reported due to rounding of fractional shares as a result of the reverse stock split.

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.

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).

Reclassifications – Certain account reclassifications and adjustments have been made to the consolidated financial statements of the prior year in order to conform to current-year presentation. These reclassifications have no effect on previously reported net income or equity.

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.

First Sound Bank

Notes to Financial Statements

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

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.

Most of the Bank's business activity is with customers located in the state of Washington. At December 31, 2018 and 2017, the Bank has \$34,551 and \$46,146, respectively, in loans in commercial real estate and construction, which represented 35% and 38%, 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 states of California and Washington each have a concentration of over 10% of the remaining EFA portfolio.

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 collectibility 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.

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

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.

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.

First Sound Bank

Notes to Financial Statements

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

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, 2018 and 2017, SBA servicing assets are not considered material and totaled \$168 and \$183, respectively, included in other assets on the balance sheets, from servicing \$5.1 million and \$8.5 million in loans, respectively.

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 \$57 and \$69 for the years ended December 31, 2018 and 2017, respectively. Accumulated amortization totaled \$49 and \$37 with amortization expense of \$12 for the years ended December 31, 2018 and 2017. 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.

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

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

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 benefit. 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

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

Recently adopted accounting pronouncements – In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606)*, which postponed the effective date of 2014-09. Subsequently, in March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations*. This amendment clarifies that an entity should determine if it is the principal or the agent for each specified good or service promised in a contract with a customer. In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*. The core principle of Topic 606 is that an entity must recognize revenue when it has satisfied a performance obligation of transferring promised goods or services to a customer. These standards were effective for interim and annual periods beginning after December 15, 2017. The Bank has analyzed its sources of noninterest income to determine when the satisfaction of the performance obligation occurs and the appropriate recognition of revenue. In accordance with Topic 606, revenues are recognized when goods or services are transferred to the customer in exchange for the consideration the Bank expects to be entitled to receive. To determine the appropriate recognition of revenue for transactions within the scope of Topic 606, the Bank performs the following five steps: (i) identify the contract(s) with the customer; (ii) identify the separate performance obligations in the contract; (iii) determine the transaction price; (iv) allocate the transaction price to the separate performance obligations in the contract; and (v) recognize revenue when the entity satisfies a performance obligation. A contract may not exist if there are doubts as to collectability of the amounts the Bank is entitled to in exchange for the goods or services transferred. If a contract is determined to be within the scope of Topic 606, the Bank recognizes revenue as it satisfies a performance obligation. The largest portion of the Bank's revenue is from net interest income, which is not within the scope of Topic 606. Finally, substantially all of the Bank's revenues under the scope of Topic 606 are for performance obligations satisfied at a specified date and the adoption of these ASUs did not have a material impact on the Bank's financial statements.

In January 2016, the FASB issued ASU No. 2016-01, *Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities*. ASU 2016-01 requires equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendments in this ASU require an entity to disclose the fair value of financial instruments using the exit price notion. Exit price is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The amendments in this ASU were effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Bank has used the exit price notion in the fair value disclosure of financial instruments in Note 15 of this report. The adoption of ASU 2016-01 did not have a material impact on the Bank's financial statements or disclosures in the Notes to the Financial Statements

First Sound Bank
Notes to Financial Statements

Note 2 – Earnings Per Common Share

Earnings per common share at December 31:

	<u>2018</u>	<u>2017</u>
Net income available to common shareholders	<u>\$ 343</u>	<u>\$ 309</u>
Basic weighted-average common shares outstanding	3,152,155	2,965,103
Plus common stock options and nonvested shares considered outstanding for dilutive purposes (excludes antidilutive options and nonvested shares)	<u>80,000</u>	<u>83,568</u>
Diluted weighted-average common shares outstanding	<u>3,232,155</u>	<u>3,048,672</u>
Basic earnings per share	<u>\$ 0.11</u>	<u>\$ 0.10</u>
Diluted earnings per share	<u>\$ 0.11</u>	<u>\$ 0.10</u>
Antidilutive shares	<u>10,250</u>	<u>10,708</u>

Note 3 – Restricted Assets

Federal Reserve Board regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank (FRB), based on a percentage of deposits. The amounts of such balances for the years ended December 31, 2018 and 2017, were approximately \$894 and \$958, respectively.

First Sound Bank

Notes to Financial Statements

Note 4 – 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:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2018				
Investment securities available for sale				
US Treasury	\$ 1,294	\$ -	\$ (3)	\$ 1,291
FHLMC mortgage-backed securities	316	-	(14)	302
	<u>\$ 1,610</u>	<u>\$ -</u>	<u>\$ (17)</u>	<u>\$ 1,593</u>
December 31, 2017				
Investment securities available for sale				
US Treasury	\$ 550	\$ -	\$ -	\$ 550
FHLMC mortgage-backed securities	414	-	(9)	405
	<u>\$ 964</u>	<u>\$ -</u>	<u>\$ (9)</u>	<u>\$ 955</u>

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
2018						
Investment securities available for sale						
US Treasury	\$ -	\$ -	\$ (3)	\$ 1,291	\$ (3)	\$ 1,291
FHLMC mortgage-backed securities	\$ -	\$ -	\$ (14)	\$ 302	\$ (14)	\$ 302
2017						
Investment securities available for sale						
FHLMC mortgage-backed securities	\$ -	\$ -	\$ (9)	\$ 405	\$ (9)	\$ 405

The Bank had four and one investment securities with gross unrealized losses for the years then ended December 31, 2018 and 2017, 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 loss is 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, 2018 or 2017.

There were no sales of securities during the years ended December 31, 2018 or 2017.

First Sound Bank
Notes to Financial Statements

Note 4 – Investment Securities Available for Sale (continued)

The amortized cost and estimated fair value of securities at December 31, 2018, by contractual or expected maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in 1 year or less	\$ -	\$ -
Due in 1 to 5 years	1,294	1,291
Due in over 5 years	<u>316</u>	<u>302</u>
	<u>\$ 1,610</u>	<u>\$ 1,593</u>

Securities carried at approximately \$1,593 and \$955 were pledged to the FRB at December 31, 2018 and 2017, respectively, for other purposes required or permitted by law.

Note 5 – Loans and Allowance for Credit Losses

Loans at December 31 consist of the following:

	<u>2018</u>	<u>2017</u>
Commercial	\$ 12,244	\$ 13,332
Real estate		
Commercial	34,108	42,468
Residential	18,709	13,246
Construction	443	3,678
Equipment finance	26,570	43,984
Consumer	645	666
Government guaranteed	<u>7,455</u>	<u>4,500</u>
	100,174	121,874
Premium on purchased loans	222	52
Deferred loan origination fees, net of costs	<u>591</u>	<u>1,064</u>
	<u>\$ 100,987</u>	<u>\$ 122,990</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 2018 and 2017. During the year ended December 31, 2018, the Bank experienced \$155 of additions and \$100 of pay-downs, with an ending balance of \$4,943. During the year ended December 31, 2017, the Bank experienced \$4,888 in additions and pay-downs of \$1,742, with an ending balance of \$4,888.

First Sound Bank

Notes to Financial Statements

Note 5 – Loans and Allowance for Credit Losses (continued)

Loans of approximately \$49,693 and \$58,219 at December 31, 2018 and 2017, respectively, were pledged to secure the available borrowings with the FHLB and FRB.

The following table presents the activity in the allowance for credit losses by segment for the years ended December 31, 2018 and 2017:

	Beginning Balance	Provision (Benefit) for Loan Losses	Charge-offs	Recoveries	Ending Balance
2018					
Commercial	\$ 170	\$ -	\$ -	\$ -	\$ 170
Real estate					
Commercial	460	-	-	-	460
Residential	42	-	-	-	42
Construction	59	-	-	-	59
Equipment finance	523	-	(125)	172	570
Consumer	17	-	-	-	17
Government guaranteed	-	-	-	-	-
Unallocated	138	-	-	-	138
	<u>\$ 1,409</u>	<u>\$ -</u>	<u>\$ (125)</u>	<u>\$ 172</u>	<u>\$ 1,456</u>
2017					
Commercial	\$ 194	\$ (37)	\$ -	\$ 13	\$ 170
Real estate					
Commercial	425	35	-	-	460
Residential	33	9	-	-	42
Construction	47	12	-	-	59
Equipment finance	577	34	(167)	79	523
Consumer	1	16	-	-	17
Government guaranteed	1	(1)	-	-	-
Unallocated	-	138	-	-	138
	<u>\$ 1,278</u>	<u>\$ 206</u>	<u>\$ (167)</u>	<u>\$ 92</u>	<u>\$ 1,409</u>

First Sound Bank
Notes to Financial Statements

Note 5 – 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
2018						
Commercial	\$ 170	\$ -	\$ 170	\$ 12,244	\$ -	\$ 12,244
Real estate						
Commercial	460	-	460	34,108	1,965	32,143
Residential	42	-	42	18,709	-	18,709
Construction	59	-	59	443	-	443
Equipment finance	570	-	570	26,570	20	26,550
Consumer	17	-	17	645	-	645
Government guaranteed	-	-	-	7,455	-	7,455
Unallocated	138	-	138	-	-	-
	<u>\$ 1,456</u>	<u>\$ -</u>	<u>\$ 1,456</u>	<u>\$ 100,174</u>	<u>\$ 1,985</u>	<u>\$ 98,189</u>
2017						
Commercial	\$ 170	\$ -	\$ 170	\$ 13,332	\$ -	\$ 13,332
Real estate						
Commercial	460	-	460	42,468	5,369	37,099
Residential	42	-	42	13,246	-	13,246
Construction	59	-	59	3,678	-	3,678
Equipment finance	523	-	523	43,984	109	43,875
Consumer	17	-	17	666	-	666
Government guaranteed	-	-	-	4,500	-	4,500
Unallocated	138	-	138	-	-	-
	<u>\$ 1,409</u>	<u>\$ -</u>	<u>\$ 1,409</u>	<u>\$ 121,874</u>	<u>\$ 5,478</u>	<u>\$ 116,396</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.

First Sound Bank

Notes to Financial Statements

Note 5 – Loans and Allowance for Credit Losses (continued)

EFAs are classified by the Bank as pass or doubtful, 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, weighted based on the total charge-offs tracked by origination date. Impaired EFAs classified as doubtful are not individually evaluated for impairment; rather, they are treated as a homogeneous pool for reserving purposes. The Bank uses a 12-month trailing average of net EFA charge-offs to derive a reserve percentage at the measurement date.

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 which, 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 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

December 31, 2018	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 12,244	\$ -	\$ -	\$ -	\$ 12,244
Real estate					
Commercial	32,143	-	1,965	-	34,108
Residential	18,709	-	-	-	18,709
Construction	443	-	-	-	443
Equipment finance	26,550	-	-	20	26,570
Consumer	645	-	-	-	645
Government guaranteed	7,455	-	-	-	7,455
	<u>\$ 98,189</u>	<u>\$ -</u>	<u>\$ 1,965</u>	<u>\$ 20</u>	<u>\$ 100,174</u>
December 31, 2017					
Commercial	\$ 13,223	\$ 59	\$ 50	\$ -	\$ 13,332
Real estate					
Commercial	37,099	-	5,369	-	42,468
Residential	13,246	-	-	-	13,246
Construction	3,678	-	-	-	3,678
Equipment finance	43,875	-	-	109	43,984
Consumer	666	-	-	-	666
Government guaranteed	4,500	-	-	-	4,500
	<u>\$ 116,287</u>	<u>\$ 59</u>	<u>\$ 5,419</u>	<u>\$ 109</u>	<u>\$ 121,874</u>

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Notes to Financial Statements

Note 5 – 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
December 31, 2018							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 12,244	\$ 12,244	\$ -
Real estate							
Commercial	-	-	1,965	1,965	32,143	34,108	-
Residential	-	-	-	-	18,709	18,709	-
Construction	-	-	-	-	443	443	-
Equipment finance	245	12	20	277	26,293	26,570	-
Consumer	-	-	-	-	645	645	-
Government guaranteed	-	-	-	-	7,455	7,455	-
	<u>\$ 245</u>	<u>\$ 12</u>	<u>\$ 1,985</u>	<u>\$ 2,242</u>	<u>\$ 97,932</u>	<u>\$ 100,174</u>	<u>\$ -</u>
December 31, 2017							
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 13,332	\$ 13,332	\$ -
Real estate							
Commercial	-	-	5,369	5,369	37,099	42,468	-
Residential	-	-	-	-	13,246	13,246	-
Construction	-	-	-	-	3,678	3,678	-
Equipment finance	457	87	109	653	43,331	43,984	-
Consumer	-	-	-	-	666	666	-
Government guaranteed	-	-	-	-	4,500	4,500	-
	<u>\$ 457</u>	<u>\$ 87</u>	<u>\$ 5,478</u>	<u>\$ 6,022</u>	<u>\$ 115,852</u>	<u>\$ 121,874</u>	<u>\$ -</u>

The following table shows impaired loans at December 31:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2018					
With related allowance recorded					
Equipment finance	\$ 20	\$ 20	\$ -	\$ 65	\$ -
With no allowance recorded					
Commercial real estate	1,965	1,965	-	3,667	-
Total					
Commercial real estate	\$ 1,965	\$ 1,965	\$ -	\$ 3,667	\$ -
Equipment finance	20	20	-	65	-
December 31, 2017					
With related allowance recorded					
Equipment finance	\$ 109	\$ 109	\$ 5	\$ 129	\$ -
With no allowance recorded					
Commercial real estate	5,369	5,369	-	2,766	-
Total					
Commercial real estate	5,369	5,369	-	2,766	-
Equipment finance	109	109	5	129	-

First Sound Bank

Notes to Financial Statements

Note 5 – Loans and Allowance for Credit Losses (continued)

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

	<u>2018</u>	<u>2017</u>
Commercial real estate	\$ 1,965	\$ 5,369
Equipment finance	<u>20</u>	<u>109</u>
	<u>\$ 1,985</u>	<u>\$ 5,478</u>

There were no loans classified as troubled debt restructurings for the years ended December 31, 2018 and 2017.

During 2018 and 2017, there were no loans modified as troubled debt restructurings.

Note 6 – Premises and Equipment

Components of premises and equipment as of December 31:

	<u>2018</u>	<u>2017</u>
Leasehold improvements	\$ 589	\$ 589
Furniture and equipment	<u>1,115</u>	<u>1,063</u>
	1,704	1,652
Less accumulated depreciation and amortization	<u>(1,522)</u>	<u>(1,498)</u>
Premises and equipment, net	<u>\$ 182</u>	<u>\$ 154</u>

Depreciation and amortization expense totaled \$36 and \$39 for the years ended December 31, 2018 and 2017, respectively.

The Bank leases its premises under operating leases that expire November 30, 2021, contains an escalation clause based on increases in property taxes and other costs. Rental expense under operating leases was \$553 and \$710 for the years ended December 31, 2018 and 2017, 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:

2019	\$ 371
2020	383
2021	<u>361</u>
	<u>\$ 1,115</u>

First Sound Bank
Notes to Financial Statements

Note 7 – Foreclosed Assets

The following table presents foreclosed assets as of December 31:

	<u>2018</u>	<u>2017</u>
Beginning balance	\$ 1,912	\$ 2,385
Sales	(177)	(273)
Gains on sales	34	-
Write-downs	<u>-</u>	<u>(200)</u>
Ending balance	<u><u>\$ 1,769</u></u>	<u><u>\$ 1,912</u></u>

Foreclosed assets includes undeveloped land at December 31, 2018 and 2017.

Note 8 – Deposits

The composition of deposits at December 31 is as follows:

	<u>2018</u>	<u>2017</u>
Demand deposits, noninterest-bearing	\$ 31,341	\$ 28,317
Savings and interest-bearing demand	66,747	62,241
Time certificates	<u>19,820</u>	<u>29,975</u>
	<u><u>\$ 117,908</u></u>	<u><u>\$ 120,533</u></u>

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

2019	\$ 18,074
2020	1,318
2021	38
2022	<u>390</u>
	<u><u>\$ 19,820</u></u>

As of December 31, 2018 and 2017, there were \$1,500 and \$3,000, respectively, of brokered deposits outstanding.

Related party deposits totaled \$1,098 and \$1,268 at December 31, 2018 and 2017, respectively.

As of December 31, 2018 and 2017, there were \$5,745 and \$5,567, respectively, of time certificates that met or exceeded the \$250 FDIC-insured limits.

First Sound Bank

Notes to Financial Statements

Note 9 – Borrowings

The Bank has a credit line with the FHLB of Des Moines totaling 25% of the Bank's assets, dependent on sufficient collateral at the time of borrowing and FHLB stock ownership. At December 31, 2018 and 2017, \$28,817 and \$23,803, respectively, was available. At December 31, 2018 and 2017, there were outstanding borrowings of \$0 and \$10 million, respectively.

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, 2018 and 2017, \$6,747 and \$8,750, respectively, was available. At December 31, 2018 and 2017, there were no outstanding borrowings on this line.

The Bank also has lines-of-credit agreements with an unaffiliated banks totaling \$8 million. These lines provide for lending at the bank's federal fund rates. There were no borrowings outstanding at December 31, 2018 and 2017.

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 \$54 and \$76 for the years ended December 31, 2018 and 2017, respectively.

Note 11 – Income Taxes

The Bank has not provided for income taxes in 2018 or 2017 as a result of the net losses incurred in previous years and carried forward.

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

	<u>2018</u>	<u>2017</u>
Deferred tax assets		
Operating loss carryforward	\$ 1,544	\$ 1,617
Intangibles	527	651
Other, net	241	238
Nonaccrual interest	26	26
Accrued rent	15	15
Fixed asset basis	106	126
Purchase accounting adjustments	9	15
	<u>2,468</u>	<u>2,688</u>
Deferred tax liabilities		
Deferred income	66	69
Loan origination costs	91	222
Allowance for credit losses	395	396
	<u>552</u>	<u>687</u>
Net deferred tax assets before valuation allowance	1,916	2,001
Valuation allowance	<u>(1,916)</u>	<u>(2,001)</u>
Net deferred tax assets	<u>\$ -</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 \$170,000 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 \$11,000 per year.

First Sound Bank

Notes to Financial Statements

Note 11 – Income Taxes (continued)

Management recorded a valuation allowance against deferred tax assets for the years ended December 31, 2018 and 2017, based on its estimate of future reversal and utilization. When determining the amount of deferred tax assets that are more likely than not to be realized and, therefore, recorded as a benefit, the Bank conducts a regular assessment of all available information. This information includes, but is not limited to, taxable income in prior periods, projected future income, and projected future reversals of deferred tax items. Based on these criteria, the Bank determined that it was necessary to retain a valuation allowance against deferred tax assets.

Prior to the impact of the Section 382 limitations, the Bank has federal net operating loss carryforwards of approximately \$54.3 million at December 31, 2018. As a result of Section 382 limitations, total usable federal operating loss carryforwards total \$7.4 million. Federal net operating loss carryforwards, to the extent not used, will begin to expire in 2028.

At December 31, 2018 and 2017, 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, 2018 and 2017, 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 2015.

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:

	<u>2018</u>	<u>2017</u>
Commitments to extend credit		
Real estate secured	\$ 5,378	\$ 10,750
Commercial lines of credit	<u>18,107</u>	<u>14,620</u>
	<u>\$ 23,485</u>	<u>\$ 25,370</u>

Note 12 – Commitments and Contingencies (continued)

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.

Note 13 – Stock Compensation Plans and Stock Warrants

Stock options – 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 of which the Bank has 10,600 and 4,933 remaining to grant as of December 31, 2018 and 2017, respectively. The Bank has 74,500 options/shares remaining to grant as of December 31, 2018 and 2017.

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. No options were granted in 2018 or 2017.

A summary of the status of the Bank's stock option plan activity for the year ended December 31, 2018, is presented below:

	Shares Underlying Options	Weighted- Average Exercise Price	Aggregate Intrinsic Value	Weighted- Average Remaining Contractual Life (Years)
Options outstanding, December 31, 2017	90,000	\$ 5.33	\$ -	
Granted	-	-	-	
Exercised	-	-	-	
Expired/forfeited	-	-	-	
Options outstanding, December 31, 2018	<u>90,000</u>	<u>\$ 5.33</u>	<u>\$ -</u>	5.06
Options exercisable, December 31, 2018	<u>90,000</u>	<u>\$ 5.33</u>	<u>\$ -</u>	5.06

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Notes to Financial Statements

Note 13 – Stock Compensation Plans and Stock Warrants (continued)

The following summarizes the restricted stock plan of nonvested shares and changes for the year ended December 31, 2018:

	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested stock grants at beginning of year	8,167	\$ 5.78
Granted	-	-
Vested	(2,500)	7.00
Expired/forfeited	<u>(5,667)</u>	<u>5.24</u>
Nonvested stock grants at end of year	<u>-</u>	<u>\$ -</u>

As of December 31, 2018, there was no unrecognized compensation cost related to nonvested share-based compensation agreements granted under both plans.

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.

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 Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1, common equity Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2018, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, common equity Tier 1, and Tier 1 leverage ratios, as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

First Sound Bank

Notes to Financial Statements

Note 14 – Regulatory Matters (continued)

The Bank's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		For Capital Adequacy with Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2018								
Tier I capital (to average assets)	\$ 13,450	10.24%	\$ 5,252	≥ 4.00%	N/A		\$ 6,565	≥ 5.00%
Tier I capital (to risk-weighted assets)	13,450	13.12%	\$ 6,153	≥ 6.00%	8,075	≥ 7.88%	\$ 8,204	≥ 8.00%
Common equity Tier 1 capital (to risk-weighted assets)	13,450	13.12%	\$ 4,615	≥ 4.50%	6,537	≥ 6.38%	\$ 6,665	≥ 6.50%
Total capital (to risk-weighted assets)	14,734	14.37%	\$ 8,204	≥ 8.00%	10,126	≥ 9.88%	\$ 10,255	≥ 10.00%
As of December 31, 2017								
Tier I capital (to average assets)	\$ 13,136	9.36%	\$ 5,617	≥ 4.00%	N/A		\$ 7,021	≥ 5.00%
Tier I capital (to risk-weighted assets)	13,136	11.04%	7,141	≥ 6.00%	8,629	≥ 7.25%	9,521	≥ 8.00%
Common equity Tier 1 capital (to risk-weighted assets)	13,136	11.04%	5,356	≥ 4.50%	6,844	≥ 5.75%	7,736	≥ 6.50%
Total capital (to risk-weighted assets)	14,565	12.24%	9,521	≥ 8.00%	11,009	≥ 9.25%	11,901	≥ 10.00%

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

First Sound Bank

Notes to Financial Statements

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 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.

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 2018 or 2017), is presented below:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
December 31, 2018				
Investment securities available for sale				
US Treasuries	\$ -	\$ 1,291	\$ -	\$ 1,291
FHLMC mortgage-backed securities	-	302	-	302
	<u>\$ -</u>	<u>\$ 1,593</u>	<u>\$ -</u>	<u>\$ 1,593</u>
December 31, 2017				
Investment securities available for sale				
US Treasuries	\$ -	\$ 550	\$ -	\$ 550
FHLMC mortgage-backed securities	-	405	-	405
	<u>\$ -</u>	<u>\$ 955</u>	<u>\$ -</u>	<u>\$ 955</u>

Note 15 – Fair Value of Financial Instruments (continued)

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). The following presents such assets carried on the balance sheet by caption and by level within the FASB ASC 820 hierarchy as of December 31:

	Level 1	Level 2	Level 3	Total Fair Value
December 31, 2018				
Impaired loans	\$ -	\$ -	\$ 1,985	\$ 1,985
Foreclosed assets	-	-	1,769	1,769
December 31, 2017				
Impaired loans	\$ -	\$ -	\$ 5,478	\$ 5,478
Foreclosed assets	-	-	1,912	1,912

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

	Fair Value at December 31, 2018	Valuation Technique	Unobservable Input	Weighted Average ¹
Impaired loans	\$ 1,985	Market comparable	Adjustment to appraisal value	7%
Foreclosed assets	1,769	Market comparable	Adjustment to appraisal value	7%

¹ Discount to appraised value

	Fair Value at December 31, 2017	Valuation Technique	Unobservable Input	Weighted Average ¹
Impaired loans	\$ 5,478	Market comparable	Adjustment to appraisal value	7%
Foreclosed assets	1,912	Market comparable	Adjustment to appraisal value	7%

¹ Discount to appraised value

Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price or the fair value of the collateral, if the loan is collateral-dependent. Changes in these values are recorded in income as an adjustment to the allowance for credit losses.

Foreclosed assets in the preceding table represent real estate or other assets that have been foreclosed and adjusted to fair value. At the time of foreclosure, these assets are recorded at the lower of the carrying amount of the loan or fair value less costs to sell, which becomes the asset's new basis. Any write-downs are based on the asset's fair value at the date of foreclosure and are charged to the allowance for credit losses. Management periodically performs valuations to determine whether the asset's fair value has further declined. Fair value adjustments are recorded as a reduction to noninterest expense.

First Sound Bank

Notes to Financial Statements

Note 15 – Fair Value of Financial Instruments (continued)

The Bank has adopted ASU 2016-01, and therefore, is measuring the fair value of loans receivable under the exit price notion rather than the previous method of entry price notion. The methodology used to estimate the fair values of other financial instruments did not change from the adoption of ASU 2016-01. Under the exit price notion used at December 31, 2018, the fair value estimate of loans receivable was based on similar techniques, with the addition of current origination spreads, liquidity premiums, or credit adjustments. The fair value of nonperforming loans is based on the underlying value of the collateral for periods prior to and after adoption of ASU 2016-01. The fair value estimate of loans receivable at December 31, 2017, was not restated under the exit price notion and was based on discounted cash flow.

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
2018				
Financial assets				
Cash and cash equivalents	\$ 27,971	\$ 27,971	\$ -	\$ -
Securities available for sale	1,593	-	1,593	-
FHLB stock	173	-	173	-
Loans, net	99,531	-	-	97,393
Accrued interest receivable	236	236	-	-
Financial liabilities				
Demand deposits	\$ 98,088	\$ 98,088	\$ -	\$ -
Time deposits	19,820	-	19,901	-
Accrued interest payable	25	25	-	-
2017				
Financial assets				
Cash and cash equivalents	\$ 18,361	\$ 18,361	\$ -	\$ -
Securities available for sale	955	-	955	-
FHLB stock	563	-	563	-
Loans, net	121,581	-	-	120,396
Accrued interest receivable	258	258	-	-
Financial liabilities				
Demand deposits	\$ 90,558	\$ 90,558	\$ -	\$ -
Time deposits	29,975	-	29,856	-
Borrowings	10,000	-	10,000	-
Accrued interest payable	24	24	-	-

Note 15 – Fair Value of Financial Instruments (continued)

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 at December 31, 2018 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.

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.

