



Report of Independent Auditors  
and Financial Statements for

**First Sound Bank**

December 31, 2016 and 2015

**MOSS-ADAMS<sub>LLP</sub>**

Certified Public Accountants | Business Consultants

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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, 2016 and 2015, 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, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Moss Adams LLP*

Everett, Washington  
March 15, 2017

**FIRST SOUND BANK**  
**BALANCE SHEETS (dollars in thousands)**

**ASSETS**

	December 31,	
	2016	2015
Cash and cash equivalents	\$ 1,275	\$ 957
Interest-bearing deposits in other financial institutions	11,371	9,077
Investment securities, available for sale	1,039	701
Federal Home Loan Bank stock, at cost	599	345
Loans	118,980	111,151
Allowance for credit losses	(1,278)	(1,422)
Net loans	117,702	109,729
Premises and equipment, net	171	61
Accrued interest receivable	226	244
Foreclosed assets, net	2,385	2,725
Other assets	837	1,369
Total assets	\$ 135,605	\$ 125,208

**LIABILITIES AND SHAREHOLDERS' EQUITY**

<b>LIABILITIES</b>		
Deposits	\$ 109,941	\$ 108,097
Borrowings	11,200	4,600
Accrued interest payable	20	14
Other liabilities	2,633	881
Total liabilities	123,794	113,592
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock (par value \$0.01); 10,000 shares authorized, no shares issued and outstanding in 2016 and 2015	-	-
Common stock (no par value); authorized: 300,000,000 shares in 2016 and 2015; issued and outstanding: 293,673,541 and 292,756,875 shares in 2016 and 2015, respectively	60,239	60,180
Accumulated deficit	(48,423)	(48,555)
Accumulated other comprehensive loss	(5)	(9)
Total shareholders' equity	11,811	11,616
Total liabilities and shareholders' equity	\$ 135,605	\$ 125,208

**FIRST SOUND BANK**  
**STATEMENTS OF INCOME (dollars in thousands)**

	Years Ended December 31,	
	2016	2015
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 4,957	\$ 4,919
Interest on deposits in other financial institutions	64	36
Interest on investments	11	4
Total interest income	5,032	4,959
<b>INTEREST EXPENSE</b>		
Deposits	553	483
Borrowings	8	10
Total interest expense	561	493
Net interest income before provision (benefit) for credit losses	4,471	4,466
<b>PROVISION (BENEFIT) FOR CREDIT LOSSES</b>	15	(165)
Net interest income after provision (benefit) for credit losses	4,456	4,631
<b>NONINTEREST INCOME</b>		
Service charge income	124	147
Sublease income	373	278
Gain on sale of loans	87	488
Bargain purchase gain	-	511
Servicing fees	5	12
Other income	226	461
Total noninterest income	815	1,897
<b>NONINTEREST EXPENSE</b>		
Salaries and benefits	2,295	2,248
Occupancy expenses	999	980
Professional and regulatory expenses	334	698
Data processing	495	462
Foreclosed assets, net	(46)	135
Insurance expense	256	250
Loan and lease expense	70	60
Other operating expenses	736	684
Total noninterest expense	5,139	5,517
<b>NET INCOME</b>	<u>\$ 132</u>	<u>\$ 1,011</u>
<b>EARNINGS PER COMMON SHARE</b>		
Basic	\$ -	\$ -
Diluted	\$ -	\$ -
<b>Weighted-average number of common shares outstanding</b>		
Basic	292,909,653	285,847,440
Diluted	296,657,096	289,036,772

**FIRST SOUND BANK**  
**STATEMENTS OF COMPREHENSIVE INCOME (dollars in thousands)**

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	Years Ended December 31,	
	<u>2016</u>	<u>2015</u>
NET INCOME	\$ 132	\$ 1,011
Other comprehensive income (loss)		
Unrealized holding gain (loss) on securities available for sale	<u>4</u>	<u>(9)</u>
Other comprehensive income (loss)	<u>4</u>	<u>(9)</u>
COMPREHENSIVE INCOME	<u>\$ 136</u>	<u>\$ 1,002</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, 2014	279,788,097	\$ 59,315	\$ (49,566)	\$ -	\$ 9,749
Net income	-	-	1,011	-	1,011
Vesting of restricted stock	877,777	-	-	-	-
Stock-based compensation	-	58	-	-	58
Unrealized loss on securities	-	-	-	(9)	(9)
Issuance of stock	5,000,001	455	-	-	455
Stock issued in connection with the acquisition of Eastside Commercial Bank	7,091,000	352	-	-	352
BALANCE, December 31, 2015	292,756,875	60,180	(48,555)	(9)	11,616
Net income	-	-	132	-	132
Vesting of restricted stock	916,666	-	-	-	-
Stock-based compensation	-	59	-	-	59
Unrealized gain on securities	-	-	-	4	4
BALANCE, December 31, 2016	<u>293,673,541</u>	<u>\$ 60,239</u>	<u>\$ (48,423)</u>	<u>\$ (5)</u>	<u>\$ 11,811</u>

**FIRST SOUND BANK**  
**STATEMENTS OF CASH FLOWS (dollars in thousands)**

	Years Ended December 31,	
	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$ 132	\$ 1,011
Adjustments to reconcile net income to net cash from operating activities		
Provision (benefit) from credit losses	15	(165)
Amortization of premiums on investment securities	10	-
Depreciation and amortization	61	54
Gain on sale of loans	(87)	(488)
Write down of foreclosed assets	-	100
Gain on sale of foreclosed assets	(24)	-
Proceeds from sale of loans	-	4,865
Stock-based compensation	59	58
Bargain purchase gain on acquisition	-	(511)
Increase (decrease) in cash due to changes in certain assets and liabilities		
Accrued interest receivable	18	(82)
Other assets	532	47
Other liabilities	1,752	147
Accrued interest payable	6	3
Net cash from operating activities	2,474	5,039
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net increase in interest-bearing deposits in other financial institutions	(2,294)	(1,245)
Purchase of securities available for sale	(499)	(1,025)
Proceeds from paydowns and maturities of securities available for sale	155	315
Loan originations, net of principal collections and sales	(7,901)	(6,542)
Change in Federal Home Loan Bank stock, net	(254)	523
Proceeds from sale of foreclosed assets	364	-
Additions to premises and equipment, net	(171)	(12)
Net cash from investing activities	(10,600)	(7,986)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net change in short-term borrowings	15,200	4,000
Paydown of long-term borrowings	(8,600)	(2,200)
Net change in deposits	1,844	(4,295)
Proceeds from issuance of stock	-	455
Cash consideration paid for acquisition	-	(111)
Cash received in the acquisition	-	4,242
Net cash from financing activities	8,444	2,091
Net increase (decrease) in cash and cash equivalents	318	(856)
CASH AND CASH EQUIVALENTS, beginning of year	957	1,813
CASH AND CASH EQUIVALENTS, end of year	\$ 1,275	\$ 957
<b>SUPPLEMENTAL CASH AND NONCASH DISCLOSURES</b>		
Cash paid during the year for interest	\$ 555	\$ 490
Stock issued in connection with the acquisition	\$ -	\$ 352
Unrealized gain (loss) on securities	\$ 4	\$ (9)
Assets acquired (liabilities assumed) in the acquisition of Eastside Commercial Bank (at fair value)		
Assets	\$ -	\$ 20,349
Liabilities	\$ -	\$ (23,617)

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 midsized businesses and middle-income individuals in western Washington. The Bank also provides small commercial equipment financing agreements (EFA) to businesses that are located throughout the United States.

On January 15, 2015, the Bank entered into a definitive purchase and assumption agreement with Eastside Commercial Bank to purchase 100% of Eastside Commercial Bank (Eastside). Eastside was a full-service institution that operated one branch in Bellevue, Washington. Eastside merged with and into First Sound Bank and the transaction was completed on April 15, 2015, with First Sound Bank as the surviving institution. The Acquisition is meant to strategically build shareholder value through expanding its customer base (Note 2).

**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 conformity 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 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 March 15, 2017, which is the date the financial statements are issued.

**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.

**Interest-bearing deposits in other financial institutions** - Interest-bearing deposits in other financial institutions mature within one year and are carried at cost. The balances in these accounts may fluctuate and, at times, exceed the insured limit set by the Federal Deposit Insurance Corporation (FDIC), which potentially subjects the Bank to credit risk. The Bank has not experienced any losses in such accounts.

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

**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 entire amount of impairment is recognized through earnings.

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, 2016 and 2015, the Bank has \$40,590 and \$37,027, respectively, in loans in commercial real estate and construction, which represented 35% and 34% of the Bank's loan portfolio, respectively. 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 Texas each have a concentration of over 10% of the 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.

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.

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

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.

**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, 2016 and 2015, SBA servicing assets are not considered material and totaled \$207 and \$302, respectively, included in other assets on the balance sheets, from servicing \$8.3 million and \$11.4 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 \$81 and \$108 for the year ended December 31, 2016 and 2015, respectively. Accumulated amortization totaled \$25 and \$11 with amortization expense of \$14 and \$11 for the year ended December 31, 2016 and 2015, 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.

**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.

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

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 value is the price to sell an asset or transfer a liability in an orderly transaction between market participants. It represents an exit price at the measurement date. Market participants are buyers and sellers who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset and liability being measured. Current market conditions, including imbalances between supply and demand, are considered in determining fair value.

In measuring the fair value of an asset, the Bank assumes the highest and best use of the asset by a market participant to maximize the value of the asset, and does not consider the intended use of the asset.

**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.

**Reclassification** - Certain reclassifications have been made to the prior-year financial statements to conform to the current-year presentation with no effect on net income or total shareholders' equity.

# FIRST SOUND BANK

## NOTES TO FINANCIAL STATEMENTS

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### Note 2 - Business Combination

On April 15, 2015, Eastside merged with and into the Bank (the Acquisition). The Acquisition was accounted for in accordance with the acquisition method of accounting with a total consideration of \$463. The Bank paid cash totaling \$111, or \$.05 per share of Eastside common stock. In addition, First Sound Bank issued common stock to the Eastside preferred stockholders (70,910,000 at \$.05 per share) that was valued at \$352. The assets and liabilities, both tangible and intangible, were recorded at their estimated fair values as of the acquisition date, and are subject to change during the measurement period after the closing date of the acquisition. Upon completion of the Acquisition, Eastside's branch was closed and moved into the Bank's sole location.

The operations of Eastside are included in the Bank's operating results from April 15, 2015, and added revenue of approximately \$1,193 and expense of \$283, and net income of \$910, net of tax for the year ended December 31, 2015. Eastside's results of operations prior to the acquisition are not included in the Bank's operating results. Acquisition-related expenses of \$160 have been incurred in connection with the acquisition of Eastside related to professional and other related expenses, within their natural classification on the statements of income. The bargain purchase gain of \$511 represents the excess of the estimated fair value of the net assets acquired over the fair value of the consideration transferred.

The estimated fair value of the assets acquired and liabilities assumed in the Acquisition were as follows:

Assets acquired	
Cash and cash equivalents	\$ 4,242
Loans receivable	19,223
Foreclosed assets	756
Core deposit intangible	108
Other assets	<u>262</u>
Total assets acquired	<u>24,591</u>
Liabilities assumed	
Deposits	23,465
Accrued expenses and other liabilities	<u>152</u>
Total liabilities assumed	<u>23,617</u>
Fair value of net assets acquired	<u>974</u>
Consideration paid	
Common stock issued (7,091,000 at \$.05 per share)	352
Cash	<u>111</u>
Fair value of consideration transferred	<u>463</u>
Bargain purchase gain	<u><u>\$ 511</u></u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 3 - Earnings Per Common Share**

Earnings per common share at December 31:

	<u>2016</u>	<u>2015</u>
Net income available to common shareholders	<u>\$ 132</u>	<u>\$ 1,011</u>
Basic weighted-average common shares outstanding	292,909,653	285,847,440
Plus common stock options and nonvested shares considered outstanding for dilutive purposes (excludes antidilutive options and nonvested shares)	<u>3,747,443</u>	<u>3,189,332</u>
Diluted weighted-average common shares outstanding	<u>296,657,096</u>	<u>289,036,772</u>
Basic earnings per share	<u>\$ -</u>	<u>\$ -</u>
Diluted earnings per share	<u>\$ -</u>	<u>\$ -</u>
Antidilutive shares	<u>981,879</u>	<u>732,148</u>

**Note 4 - 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, 2016 and 2015, were approximately \$1,127 and \$595, respectively.



**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 5 - 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, 2016</b>				
Investment securities available for sale				
US Treasury	\$ 499	\$ -	\$ -	\$ 499
FHLMC mortgage-backed securities	545	-	(5)	540
	<u>\$ 1,044</u>	<u>\$ -</u>	<u>\$ (5)</u>	<u>\$ 1,039</u>
<b>December 31, 2015</b>				
Investment securities available for sale				
FHLMC mortgage-backed securities	\$ 710	\$ -	\$ (9)	\$ 701

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:

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>	<u>Unrealized Losses</u>	<u>Estimated Fair Value</u>
<b>2016</b>						
Investment securities available for sale						
FHLMC mortgage-backed securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (5)</u>	<u>\$ 540</u>	<u>\$ (5)</u>	<u>\$ 540</u>
<b>2015</b>						
Investment securities available for sale						
FHLMC mortgage-backed securities	<u>\$ (9)</u>	<u>\$ 701</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (9)</u>	<u>\$ 701</u>

At December 31, 2016, the Bank had one investment security with gross unrealized losses. At December 31, 2015, the Bank had one investment security with gross unrealized losses. The Bank does not consider these investment securities to be other-than-temporarily impaired.

The credit loss on a security is measured as the difference between the amortized cost basis and the present value of the cash flows expected to be collected. Projected cash flows are discounted by the original or current effective interest rate depending on the nature of the security being measured for potential OTTI.

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 5 - Investment Securities Available for Sale (continued)**

The remaining impairment related to all other factors, i.e., the difference between the present value of the cash flows expected to be collected and fair value, is recognized as a charge to other comprehensive loss. Impairment losses related to all other factors are presented as separate categories within other comprehensive income (loss).

The amortized cost and estimated fair value of securities at December 31, 2016, 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.

There were no sales of securities during the years ended December 31, 2016 or 2015.

	Amortized Cost	Fair Value
Due in 1 year or less	\$ 250	\$ 250
Due in 1 to 5 years	249	249
Due in over 10 years	545	540
	<u>\$ 1,044</u>	<u>\$ 1,039</u>

Securities carried at approximately \$1,039 and \$701 were pledged to the FRB at December 31, 2016 and 2015, respectively, for other purposes required or permitted by law.

**Note 6 - Loans and Allowance for Credit Losses**

Loans at December 31 consist of the following:

	2016	2015
Commercial	\$ 14,905	\$ 15,055
Real estate		
Commercial	37,705	35,052
Residential	10,356	10,701
Construction	2,885	1,975
Equipment finance	46,393	40,495
Consumer	603	307
Government guaranteed	4,803	6,007
	<u>117,650</u>	<u>109,592</u>
Premium on purchased loans	69	152
Deferred loan origination fees, net of costs	1,261	1,407
	<u>\$ 118,980</u>	<u>\$ 111,151</u>

# FIRST SOUND BANK

## NOTES TO FINANCIAL STATEMENTS

### Note 6 - Loans and Allowance for Credit Losses (continued)

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 2016 and 2015. There were loans totaling approximately \$1,783 as of December 31, 2015, to key officers and directors. During the year ended December 31, 2016, the Bank experienced no additions and pay-downs of \$41, with an ending balance of \$1,742 as of December 31, 2016.

Loans of approximately \$25,380 and \$25,814 at December 31, 2016 and 2015, respectively, were pledged to secure the FHLB and Federal Reserve Bank of San Francisco.

The following table presents the activity in the allowance for credit losses by segment for the years ended December 31, 2016 and 2015:

	Beginning Balance	Provision (Benefit) for Loan Losses	Charge-offs	Recoveries	Ending Balance
<b>2016</b>					
Commercial	\$ 221	\$ (109)	\$ -	\$ 82	\$ 194
Real estate					
Commercial	388	37	-	-	425
Residential	61	(28)	-	-	33
Construction	27	18	-	2	47
Equipment finance	694	126	(410)	167	577
Consumer	5	(4)	-	-	1
Government guaranteed	-	1	-	-	1
Unallocated	26	(26)	-	-	-
	<u>\$ 1,422</u>	<u>\$ 15</u>	<u>\$ (410)</u>	<u>\$ 251</u>	<u>\$ 1,278</u>
<b>2015</b>					
Commercial	\$ 194	\$ (438)	\$ (66)	\$ 531	\$ 221
Real estate					
Commercial	299	82	-	7	388
Residential	45	16	-	-	61
Construction	32	(82)	-	77	27
Equipment finance	671	284	(314)	53	694
Consumer	1	4	-	-	5
Government guaranteed	-	-	-	-	-
Unallocated	57	(31)	-	-	26
	<u>\$ 1,299</u>	<u>\$ (165)</u>	<u>\$ (380)</u>	<u>\$ 668</u>	<u>\$ 1,422</u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 6 - 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>2016</b>						
Commercial	\$ 194	\$ -	\$ 194	\$ 14,905	\$ -	\$ 14,905
Real estate						
Commercial	425	-	425	37,705	163	37,542
Residential	33	-	33	10,356	-	10,356
Construction	47	-	47	2,885	-	2,885
Equipment finance	577	-	577	46,393	-	46,393
Consumer	1	-	1	603	-	603
Government guaranteed	1	-	1	4,803	-	4,803
Unallocated	-	-	-	-	-	-
	<u>\$ 1,278</u>	<u>\$ -</u>	<u>\$ 1,278</u>	<u>\$ 117,650</u>	<u>\$ 163</u>	<u>\$ 117,487</u>
<b>2015</b>						
Commercial	\$ 221	\$ -	\$ 221	\$ 15,055	\$ 172	\$ 14,883
Real estate						
Commercial	388	-	388	35,052	215	34,837
Residential	61	-	61	10,701	-	10,701
Construction	27	-	27	1,975	-	1,975
Equipment finance	694	-	694	40,314	-	40,314
Consumer	5	-	5	307	-	307
Government guaranteed	-	-	-	6,007	-	6,007
Unallocated	26	-	26	-	-	-
	<u>\$ 1,422</u>	<u>\$ -</u>	<u>\$ 1,422</u>	<u>\$ 109,411</u>	<u>\$ 387</u>	<u>\$ 109,024</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 6 - Loans and Allowance for Credit Losses (continued)

EFA's are classified by the Bank as pass or doubtful, depending on the payment status of the borrower. Pass EFA's 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 EFA's 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

<b>December 31, 2016</b>	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 14,738	\$ 167	\$ -	\$ -	\$ 14,905
Real estate					
Commercial	34,638	2,026	1,041	-	37,705
Residential	10,356	-	-	-	10,356
Construction	2,885	-	-	-	2,885
Equipment finance	46,244	-	-	149	46,393
Consumer	603	-	-	-	603
Government guaranteed	4,803	-	-	-	4,803
	<u>\$ 114,267</u>	<u>\$ 2,193</u>	<u>\$ 1,041</u>	<u>\$ 149</u>	<u>\$ 117,650</u>
<b>December 31, 2015</b>					
Commercial	\$ 13,582	\$ 1,119	\$ 354	\$ -	\$ 15,055
Real estate					
Commercial	32,794	-	2,258	-	35,052
Residential	9,966	735	-	-	10,701
Construction	1,975	-	-	-	1,975
Equipment finance	40,314	-	-	181	40,495
Consumer	307	-	-	-	307
Government guaranteed	6,007	-	-	-	6,007
	<u>\$ 104,945</u>	<u>\$ 1,854</u>	<u>\$ 2,612</u>	<u>\$ 181</u>	<u>\$ 109,592</u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 6 - 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, 2016</b>							
Commercial	\$ 1,055	\$ -	\$ -	\$ 1,055	\$ 13,850	\$ 14,905	\$ -
Real estate							
Commercial	-	-	13	13	37,692	37,705	-
Residential	-	-	-	-	10,356	10,356	-
Construction	-	-	-	-	2,885	2,885	-
Equipment finance	-	42	149	191	46,202	46,393	-
Consumer	-	-	-	-	603	603	-
Government guaranteed	-	721	-	721	4,082	4,803	-
	<u>\$ 1,055</u>	<u>\$ 763</u>	<u>\$ 162</u>	<u>\$ 1,980</u>	<u>\$ 115,670</u>	<u>\$ 117,650</u>	<u>\$ -</u>
<b>December 31, 2015</b>							
Commercial	\$ 107	\$ -	\$ 172	\$ 279	\$ 14,776	\$ 15,055	\$ -
Real estate							
Commercial	-	158	-	158	34,894	35,052	-
Residential	-	-	-	-	10,701	10,701	-
Construction	-	-	-	-	1,975	1,975	-
Equipment finance	172	29	181	382	40,113	40,495	-
Consumer	201	-	-	201	106	307	-
Government guaranteed	-	-	-	-	6,007	6,007	-
	<u>\$ 480</u>	<u>\$ 187</u>	<u>\$ 353</u>	<u>\$ 1,020</u>	<u>\$ 108,572</u>	<u>\$ 109,592</u>	<u>\$ -</u>

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

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 6 - Loans and Allowance for Credit Losses (continued)**

The following table shows impaired loans at December 31:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<b>December 31, 2016</b>					
With related allowance recorded					
Equipment finance	\$ 149	\$ 149	\$ 7	\$ 165	\$ -
With no allowance recorded					
Commercial	-	-	-	86	-
Commercial real estate	163	257	-	189	8
Total					
Commercial	\$ -	\$ -	\$ -	\$ 86	\$ -
Commercial real estate	163	257	-	189	8
Equipment finance	149	149	7	165	-
<b>December 31, 2015</b>					
With related allowance recorded					
Equipment finance	\$ 181	\$ 181	\$ 9	\$ 91	\$ -
With no allowance recorded					
Commercial	172	1,319	-	324	8
Commercial real estate	215	215	-	161	8
Total					
Commercial	\$ 172	\$ 1,319	\$ -	\$ 324	\$ 8
Commercial real estate	215	215	-	161	8
Equipment finance	181	181	9	91	-

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

	<u>2016</u>	<u>2015</u>
Commercial	\$ -	\$ 172
Commercial real estate	163	215
Equipment finance	149	181
	<u>\$ 312</u>	<u>\$ 568</u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 6 - Loans and Allowance for Credit Losses (continued)**

Loans classified as troubled debt restructurings totaled \$0 and \$172 at December 31, 2016 and 2015, respectively. These loans are included in the impaired loan disclosures. A troubled debt restructuring is a loan to a borrower that is experiencing financial difficulty that has been modified from its original terms and conditions in such a way that the Bank is granting the borrower a concession of some kind. The Bank has granted a variety of concessions to borrowers in the form of loan modifications, such as rate, term, payment, or a combination thereof.

During 2016 and 2015, there were no loans modified as troubled debt restructurings.

**Note 7 - Premises and Equipment**

Components of premises and equipment are as follows:

	<u>2016</u>	<u>2015</u>
Leasehold improvements	\$ 589	\$ 478
Furniture and equipment	<u>1,061</u>	<u>1,302</u>
	1,650	1,780
Less accumulated depreciation and amortization	<u>(1,479)</u>	<u>(1,719)</u>
Premises and equipment, net	<u><u>\$ 171</u></u>	<u><u>\$ 61</u></u>

Depreciation and amortization expense totaled \$61 and \$54 for the years ended December 31, 2016 and 2015, respectively.

The Bank leases its premises under operating leases. 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:

2017	\$ 611
2018	369
2019	371
2020	383
2021	<u>361</u>
	<u><u>\$ 2,095</u></u>



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**NOTES TO FINANCIAL STATEMENTS**

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**Note 7 - Premises and Equipment (continued)**

The lease pertaining to the Bank headquarters, with a lease term through November 30, 2021, contains an escalation clause based on increases in property taxes and other costs. Rental expense under operating leases was \$876 and \$899 for the years ended December 31, 2016 and 2015, respectively. The Bank also leases two office spaces in Bellevue and Factoria, with the Factoria lease acquired through the Eastside Commercial Bank acquisition, which have lease terms through May 2017 and January 2018.

The office spaces in Bellevue and Factoria were subleased to separate third parties. Minimum rental receipts under sublease agreement for future years ending December 31 are as follows:

2017	\$ 248
2018	<u>9</u>
	<u>\$ 257</u>

**Note 8 - Foreclosed Assets**

The following table presents foreclosed assets as of December 31:

	<u>2016</u>	<u>2015</u>
Beginning balance	\$ 2,725	\$ 2,069
Transfers through acquisition of Eastside Commercial Bank	-	756
Sales	(364)	-
Gains on sales	24	-
Write-downs	<u>-</u>	<u>(100)</u>
Ending balance	<u>\$ 2,385</u>	<u>\$ 2,725</u>

Foreclosed assets include land and single-family residences at December 31, 2016 and 2015.

**Note 9 - Deposits**

The composition of deposits at December 31 is as follows:

	<u>2016</u>	<u>2015</u>
Demand deposits, noninterest-bearing	\$ 30,696	\$ 36,072
Savings and interest-bearing demand	50,080	45,964
Time certificates	<u>29,165</u>	<u>26,061</u>
	<u>\$ 109,941</u>	<u>\$ 108,097</u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 9 - Deposits (continued)**

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

2017	\$ 27,661
2018	357
2019	1,109
2020	-
2021	<u>38</u>
	<u>\$ 29,165</u>

As of December 31, 2016 and 2015, there were \$1,030 and \$3,216, respectively, of brokered deposits outstanding.

Related party deposits totaled \$2,963 and \$831 at December 31, 2016 and 2015, respectively.

As of December 31, 2016 and 2015, there were \$3,340 and \$2,052 of time certificates that met or exceeded the \$250 FDIC-insured limits.

**Note 10 - 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, 2016 and 2015, \$1,470 and \$8,026, respectively, was available.

The details of the borrowings are as follows at December 31, 2016:

	<u>Amount</u>	<u>Rate</u>
Overnight borrowings, variable rate borrowing	\$ 7,000	0.81%
Borrowing, matures January 2017, fixed rate	<u>4,200</u>	0.73%
	<u>\$ 11,200</u>	

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, 2016 and 2015, \$6,526 and \$6,154, respectively, was available. At December 31, 2016 and 2015, there were no outstanding borrowings on this line.

The Bank also has a line-of-credit agreement with an unaffiliated bank totaling \$3 million. This line provides for lending at the bank's federal fund rates. There were no borrowings outstanding at December 31, 2016 and 2015.

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 11 - Employee Benefits**

The Bank has a combined 401(k) and profit sharing plan, and a money purchase 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 \$75 and \$66 for the years ended December 31, 2016 and 2015, respectively.

**Note 12 - Income Taxes**

The Bank has not provided for income taxes in 2016 or 2015 as a result of the net losses incurred 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>2016</u>	<u>2015</u>
Deferred tax assets		
Operating loss carryforward	\$ 2,717	\$ 2,187
Intangibles	1,255	1,456
Other, net	324	304
Nonaccrual interest	5	167
Accrued rent	8	26
Fixed asset basis	180	192
Purchase accounting adjustments	<u>110</u>	<u>197</u>
Total deferred tax assets	<u>4,599</u>	<u>4,529</u>
Deferred tax liabilities		
Deferred income	(1)	99
Loan origination costs	538	508
Allowance for credit losses	<u>713</u>	<u>493</u>
Total deferred tax liabilities	<u>1,250</u>	<u>1,100</u>
Net deferred tax assets before valuation allowance	3,349	3,429
Valuation allowance	<u>(3,349)</u>	<u>(3,429)</u>
Net deferred tax assets	<u>\$ -</u>	<u>\$ -</u>

**Note 12 - Income Taxes (continued)**

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 Eastside are subject to Section 382 annual limitations in the amount of approximately \$11,000 per year. At December 31, 2016, the net operating losses not subject to limitations are estimated to be \$4.4 million.

Management recorded a valuation allowance against deferred tax assets for the years ended December 31, 2016 and 2015, 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 \$55.0 million at December 31, 2016. As a result of Section 382 limitations, total usable federal operating loss carryforwards total \$8.0 million. Federal net operating loss carryforwards, to the extent not used, will begin to expire in 2025.

The Bank applies the provisions of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740 that require the application of a more-likely-than-not recognition. The Bank is no longer subject to examination by taxing authorities for years before 2013. The Bank had no unrecognized tax benefits at December 31, 2016 or 2015, and recognized no interest or penalties.

**Note 13 - 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.

# FIRST SOUND BANK

## NOTES TO FINANCIAL STATEMENTS

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### Note 13 - Commitments and Contingencies (continued)

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

	<u>2016</u>	<u>2015</u>
Commitments to extend credit		
Real estate secured	\$ 5,659	\$ 2,904
Commercial lines of credit	<u>14,260</u>	<u>17,232</u>
Total commitments to extend credit	<u>\$ 19,919</u>	<u>\$ 20,136</u>

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 14 - Stock Compensation Plans and Stock Warrants

**Stock options** - In January 2006, the Bank adopted the 2006 restricted stock plan (the Plan). The Plan, amended in 2008, authorized the grant of equity awards as long as the number of shares of common stock granted under the Plan added to the number of options granted under the 2004 Plan does not exceed 528,675 shares. The 2006 plan expired during January 2016.

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 20,300,000 shares for grant, subject to no more than 4,060,000 shares being issued as restricted stock grants or restricted stock unit awards. The Bank has 7,450,001 options/shares remaining to grant as of December 31, 2016.

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.

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 14 - Stock Compensation Plans and Stock Warrants (continued)**

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 inputs for options granted in 2016 and 2015 is presented below.

	<u>2016</u>	<u>2015</u>
Risk-free interest rate	1.44%	1.47%
Dividend yield rate	0.00%	0.00%
Expected volatility	36.01%	39.89%
Expected term (in years)	5 years	5 years

A summary of the status of the Bank's stock option plan activity for the year ended December 31, 2016, is presented below:

	<u>Shares Underlying Options</u>	<u>Weighted- Average Exercise Price</u>	<u>Aggregate Intrinsic Value</u>	<u>Weighted- Average Remaining Contractual Life (Years)</u>
Options outstanding, December 31, 2015	8,506,945	\$ 0.06	\$ -	
Granted	500,000	0.07	-	
Exercised	-	-	-	
Expired/forfeited	<u>(6,945)</u>	<u>11.31</u>	<u>-</u>	
Options outstanding, December 31, 2016	<u>9,000,000</u>	<u>\$ 0.05</u>	<u>\$ -</u>	7.06
Options exercisable, December 31, 2016	<u>9,000,000</u>	<u>\$ 0.05</u>	<u>\$ -</u>	7.06

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

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**Note 14 - 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, 2016:

	Shares	Weighted-Average Grant-Date Fair Value
	<u>Shares</u>	<u>Fair Value</u>
Nonvested stock grants at beginning of year	1,466,667	\$ 0.04
Granted	1,200,000	0.07
Vested	(916,667)	0.06
Expired/forfeited	<u>(583,334)</u>	<u>0.05</u>
Nonvested stock grants at end of year	<u>1,166,666</u>	<u>\$ 0.07</u>

As of December 31, 2016, there was \$67 of unrecognized compensation cost related to nonvested share-based compensation agreements granted under both plans expected to be recognized over three years.

**Note 15 - 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, 2016, 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 15 - Regulatory Matters (continued)**

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

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>As of December 31, 2016</b>						
Tier I capital (to average assets)	\$ 11,756	9.26%	\$ 5,078	≥ 4.00%	\$ 6,347	≥ 5.00%
Tier I capital (to risk-weighted assets)	11,756	10.00%	7,054	≥ 6.00%	11,756	≥ 8.00%
Common equity Tier 1 capital (to risk-weighted assets)	11,756	10.00%	5,290	≥ 4.50%	7,642	≥ 6.50%
Total capital (to risk-weighted assets)	13,054	11.10%	9,405	≥ 8.00%	11,756	≥ 10.00%
<b>As of December 31, 2015</b>						
Tier I capital (to average assets)	\$ 11,567	9.18%	\$ 5,038	≥ 4.00%	\$ 6,298	≥ 5.00%
Tier I capital (to risk-weighted assets)	11,567	10.31%	6,733	≥ 6.00%	8,977	≥ 8.00%
Common equity Tier 1 capital (to risk-weighted assets)	11,567	10.31%	5,049	≥ 4.50%	7,294	≥ 6.50%
Total capital (to risk-weighted assets)	12,970	11.56%	8,977	≥ 8.00%	11,221	≥ 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 2016 is 0.625%. 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, 2016, the Bank meets all capital adequacy requirements to which it is subject.



# FIRST SOUND BANK

## NOTES TO FINANCIAL STATEMENTS

### Note 16 - 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.

FASB 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 measurements in 2016 or 2015), is presented below:

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
<b>December 31, 2016</b>				
Investment securities available for sale				
US Treasuries	\$ -	\$ 499	\$ -	\$ 499
FHLMC mortgage-backed securities	-	540	-	540
	<u>\$ -</u>	<u>\$ 1,039</u>	<u>\$ -</u>	<u>\$ 1,039</u>
<b>December 31, 2015</b>				
Investment securities available for sale				
FHLMC mortgage-backed securities	\$ -	\$ 701	\$ -	\$ 701
	<u>\$ -</u>	<u>\$ 701</u>	<u>\$ -</u>	<u>\$ 701</u>

**FIRST SOUND BANK**  
**NOTES TO FINANCIAL STATEMENTS**

**Note 16 - 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
<b>December 31, 2016</b>				
Impaired loans	\$ -	\$ -	\$ 312	\$ 312
Foreclosed assets	-	-	2,385	2,385
<b>December 31, 2015</b>				
Impaired loans	\$ -	\$ -	\$ 568	\$ 568
Foreclosed assets	-	-	2,725	2,725

**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, 2016 and 2015, along with the valuation techniques used, are shown in the following table:

	Fair Value at December 31, 2016	Valuation Technique	Unobservable Input	Weighted Average <sup>1</sup>
Impaired loans	\$ 312	Market comparable	Adjustment to appraisal value	7%
Foreclosed assets	2,385	Market comparable	Adjustment to appraisal value	7%

<sup>1</sup> Discount to appraised value

	Fair Value at December 31, 2015	Valuation Technique	Unobservable Input	Weighted Average <sup>1</sup>
Impaired loans	\$ 568	Market comparable	Adjustment to appraisal value	10%
Foreclosed assets	2,725	Market comparable	Adjustment to appraisal value	7%

<sup>1</sup> Discount to appraised value

The Bank considers loans impaired when it is probable that the Bank will not be able to collect all amounts as scheduled under a loan agreement. 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 16 - 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>2016</b>				
Financial assets				
Cash and cash equivalents	\$ 1,275	\$ 1,275	\$ -	\$ -
Interest-bearing deposits in other financial institutions	11,371	11,371	-	-
Securities available for sale	1,039	-	1,039	-
FHLB stock	599	-	599	-
Loans, net	117,702	-	-	118,723
Accrued interest receivable	226	226	-	-
Financial liabilities				
Demand deposits	\$ 80,776	\$ 80,776	\$ -	\$ -
Time deposits	29,165	-	29,077	-
Borrowings	11,200	-	11,193	-
Accrued interest payable	20	20	-	-
<b>2015</b>				
Financial assets				
Cash and cash equivalents	\$ 957	\$ 957	\$ -	\$ -
Interest-bearing deposits in other financial institutions	9,077	9,077	-	-
Securities available for sale	701	-	701	-
FHLB stock	345	-	345	-
Loans, net	109,729	-	-	112,135
Accrued interest receivable	244	244	-	-
Financial liabilities				
Demand deposits	\$ 82,036	\$ 82,036	\$ -	\$ -
Time deposits	26,061	-	26,012	-
Borrowings	4,600	-	4,589	-
Accrued interest payable	14	14	-	-

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** - For variable-rate loans that reprice frequently and have no significant change in credit risk, fair value is based on carrying value. The fair value of fixed-rate loans is estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The fair value of impaired loans is estimated using discounted cash flow analyses or underlying collateral values, where applicable.

**Note 16 - 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.