



Report of Independent Auditors
and Financial Statements for

Puget Sound Bank

December 31, 2014 and 2013

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Stockholders
Puget Sound Bank

Report on Financial Statements

We have audited the accompanying financial statements of Puget Sound Bank (the Bank), which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income, comprehensive income, changes in stockholders' 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 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 Puget Sound Bank as of December 31, 2014 and 2013, 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.



Everett, Washington
March 17, 2015

PUGET SOUND BANK **BALANCE SHEETS**

ASSETS

	December 31,	
	2014	2013
CASH AND DUE FROM BANKS	\$ 18,137,860	\$ 16,627,030
INTEREST-BEARING DEPOSITS IN BANKS	9,961,006	4,205,567
SECURITIES AVAILABLE-FOR-SALE, at fair value	39,445,706	37,928,438
FEDERAL HOME LOAN BANK STOCK AND PACIFIC COAST BANKERS' BANK STOCK, at cost	585,700	578,600
LOANS	315,015,292	274,910,676
Less allowance for loan losses	<u>4,013,425</u>	<u>3,538,195</u>
Total loans, net	<u>311,001,867</u>	<u>271,372,481</u>
LEASEHOLDS AND EQUIPMENT, net	386,147	649,252
ACCRUED INTEREST RECEIVABLE	894,339	879,431
BANK-OWNED LIFE INSURANCE, net	2,980,895	2,885,657
DEFERRED TAX ASSET, net	1,745,000	1,415,000
GOODWILL	1,995,000	1,995,000
OTHER ASSETS	<u>595,669</u>	<u>726,355</u>
Total assets	<u><u>\$ 387,729,189</u></u>	<u><u>\$ 339,262,811</u></u>

LIABILITIES AND STOCKHOLDERS' EQUITY

DEPOSITS		
Noninterest-bearing	\$ 177,372,542	\$ 122,026,706
Interest-bearing	<u>159,220,000</u>	<u>158,740,223</u>
Total deposits	<u>336,592,542</u>	<u>280,766,929</u>
ACCRUED INTEREST PAYABLE	37,531	35,825
BORROWINGS	-	12,000,000
OTHER LIABILITIES	<u>2,650,851</u>	<u>1,991,218</u>
Total liabilities	<u>339,280,924</u>	<u>294,793,972</u>
STOCKHOLDERS' EQUITY		
Preferred stock, \$0 par value, 25,000 shares authorized, 9,886 issued and outstanding as senior preferred stock at December 31, 2014 and 2013, respectively	-	-
Senior preferred stock, \$1,000 par value, 9,886 shares authorized, 9,886 Series C shares issued and outstanding at December 31, 2014 and 2013, respectively	9,886,000	9,886,000
Common stock, \$1 par value, 10,000,000 shares authorized, 2,991,434 and 2,933,564 issued and outstanding at December 31, 2014 and 2013, respectively	2,991,434	2,933,564
Additional paid-in capital	28,663,342	28,133,950
Retained earnings	7,037,715	3,913,149
Accumulated other comprehensive loss	<u>(130,226)</u>	<u>(397,824)</u>
Total stockholders' equity	<u>48,448,265</u>	<u>44,468,839</u>
Total liabilities and stockholders' equity	<u><u>\$ 387,729,189</u></u>	<u><u>\$ 339,262,811</u></u>

PUGET SOUND BANK

STATEMENTS OF INCOME

	Years Ended December 31,	
	2014	2013
INTEREST INCOME		
Loans, including fees	\$ 14,041,001	\$ 11,971,329
Investments	687,631	656,994
Interest-bearing deposits in banks	18,552	35,133
Total interest income	14,747,184	12,663,456
INTEREST EXPENSE		
Deposits	610,077	589,440
Borrowings	33,070	6,232
Total interest expense	643,147	595,672
NET INTEREST INCOME	14,104,037	12,067,784
PROVISION FOR LOAN LOSSES	612,557	441,141
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	13,491,480	11,626,643
NONINTEREST INCOME		
Service fees	572,571	486,677
Increase in cash surrender value of bank-owned life insurance	95,238	94,776
Gain on sale of loans	1,682	48,268
Gain on sale of securities	4,423	10,482
Other income	-	397
Total noninterest income	673,914	640,600
NONINTEREST EXPENSE		
Salaries and employee benefits	5,960,192	5,017,271
Occupancy and equipment	1,035,723	905,151
Professional services	434,470	987,812
Data processing	440,967	507,087
FDIC insurance	181,000	182,454
Other expenses	1,410,055	1,285,530
Total noninterest expense	9,462,407	8,885,305
NET INCOME BEFORE PROVISION FOR INCOME TAX EXPENSE	4,702,987	3,381,938
Provision for income tax expense	1,479,561	1,217,498
NET INCOME AFTER PROVISION FOR INCOME TAX EXPENSE	3,223,426	2,164,440
Preferred stock dividends	98,860	98,860
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 3,124,566	\$ 2,065,580
Earnings per share		
Basic	\$ 1.06	\$ 0.77
Diluted	\$ 1.01	\$ 0.75

PUGET SOUND BANK
STATEMENTS OF COMPREHENSIVE INCOME

	Years Ended December 31,	
	2014	2013
NET INCOME	<u>\$ 3,223,426</u>	<u>\$ 2,164,440</u>
Other comprehensive income (loss), net of tax		
Unrealized gain (loss) on securities		
Unrealized holding gain (loss), net of tax (benefit) of		
\$139,357 and (\$329,725), respectively	270,517	(640,054)
Reclassification adjustments for realized gains on		
sales of securities, net of taxes of \$1,504 and		
\$3,564, respectively	<u>(2,919)</u>	<u>(6,918)</u>
Other comprehensive income (loss)	<u>267,598</u>	<u>(646,972)</u>
COMPREHENSIVE INCOME	<u><u>\$ 3,491,024</u></u>	<u><u>\$ 1,517,468</u></u>

PUGET SOUND BANK **STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**

	Senior Preferred Stock		Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Number of Shares	Amount	Number of Shares	Amount				
BALANCE, December 31, 2012	9,886	\$ 9,886,000	2,364,488	\$ 2,364,488	\$ 21,515,177	\$ 1,847,569	\$ 249,148	\$ 35,862,382
Vested share awards	-	-	14,125	14,125	(14,125)	-	-	-
Preferred stock cash dividend	-	-	-	-	-	(98,860)	-	(98,860)
Stock issued in lieu of compensation	-	-	12,535	12,535	156,813	-	-	169,348
Stock compensation expense	-	-	-	-	224,158	-	-	224,158
Exercise of stock options	-	-	5,500	5,500	49,500	-	-	55,000
Stock issued in connection with the acquisition of Core Business Bank	-	-	536,916	536,916	6,202,427	-	-	6,739,343
Net income	-	-	-	-	-	2,164,440	-	2,164,440
Unrealized loss on securities, net of benefit	-	-	-	-	-	-	(646,972)	(646,972)
BALANCE, December 31, 2013	9,886	9,886,000	2,933,564	2,933,564	28,133,950	3,913,149	(397,824)	44,468,839
Vested share awards	-	-	26,035	26,035	(26,035)	-	-	-
Preferred stock cash dividend	-	-	-	-	-	(98,860)	-	(98,860)
Stock issued in lieu of compensation	-	-	12,135	12,135	169,283	-	-	181,418
Stock compensation expense	-	-	-	-	195,908	-	-	195,908
Exercise of stock options	-	-	19,700	19,700	128,578	-	-	148,278
Excess tax benefits from stock compensation	-	-	-	-	61,658	-	-	61,658
Net income	-	-	-	-	-	3,223,426	-	3,223,426
Unrealized gain on securities, net of tax	-	-	-	-	-	-	267,598	267,598
BALANCE, December 31, 2014	<u>9,886</u>	<u>\$ 9,886,000</u>	<u>2,991,434</u>	<u>\$ 2,991,434</u>	<u>\$ 28,663,342</u>	<u>\$ 7,037,715</u>	<u>\$ (130,226)</u>	<u>\$ 48,448,265</u>

PUGET SOUND BANK **STATEMENTS OF CASH FLOWS**

	Years Ended December 31,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 3,223,426	\$ 2,164,440
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	612,557	441,141
Provision for off-balance-sheet commitments	35,648	10,349
Gain on sale of loans	(1,682)	(48,268)
Amortization of loan fees	(427,535)	(244,496)
Depreciation and amortization	306,146	208,957
Gain on sale of available-for-sale securities	(4,423)	(10,482)
Net amortization of securities	456,590	545,657
Increase in cash surrender value of bank-owned life insurance	(95,238)	(94,776)
Stock issued in lieu of compensation	181,418	169,348
Stock compensation expense	195,908	224,158
Deferred tax provision	(475,000)	(208,000)
Changes in operating assets and liabilities		
Accrued interest receivable	(14,908)	(127,651)
Other assets	116,924	645,087
Accrued interest payable	1,706	(3,802)
Other liabilities	623,985	(485,078)
Net cash from operating activities	<u>4,735,522</u>	<u>3,186,584</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Net change in interest-bearing deposits in banks	(5,755,439)	8,143,208
Activity in available-for-sale securities		
Proceeds from sales	651,321	2,261,937
Maturities, prepayments, and calls	8,784,836	7,173,925
Purchases	(10,979,232)	(5,046,684)
(Purchase) redemption of Federal Home Loan Bank stock	(7,100)	15,700
Proceeds from sale of loans	1,956,435	65,959
Net change in loans made to customers	(41,769,161)	(26,751,045)
Net additions to leaseholds and equipment	<u>(43,041)</u>	<u>(210,611)</u>
Net cash from investing activities	<u>(47,161,381)</u>	<u>(14,347,611)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in noninterest-bearing deposits	55,345,836	(2,259,296)
Net increase in interest-bearing deposits	479,777	5,748,694
Advances from the Federal Home Loan Bank	277,500,000	75,500,000
Repayments of advances from the Federal Home Loan Bank	(289,500,000)	(63,500,000)
Proceeds from exercise of stock options	148,278	55,000
Cash consideration for the Acquisition	-	(1,685,657)
Cash acquired in the Acquisition	-	5,125,300
Excess tax benefits from stock compensation	61,658	-
Dividends on preferred stock	<u>(98,860)</u>	<u>(98,860)</u>
Net cash from financing activities	<u>43,936,689</u>	<u>18,885,181</u>
NET CHANGE IN CASH AND DUE FROM BANKS	<u>1,510,830</u>	<u>7,724,154</u>
CASH AND DUE FROM BANKS, beginning of year	<u>16,627,030</u>	<u>8,902,876</u>
CASH AND DUE FROM BANKS, end of year	<u><u>\$ 18,137,860</u></u>	<u><u>\$ 16,627,030</u></u>

See accompanying notes.

PUGET SOUND BANK
STATEMENTS OF CASH FLOWS (continued)

	Years Ended December 31,	
	2014	2013
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the period for interest	<u>\$ 641,441</u>	<u>\$ 599,474</u>
Cash paid during the period for federal income taxes	<u>\$ 1,875,000</u>	<u>\$ 1,400,000</u>
Change in unrealized gain (loss) on securities available-for-sale	<u>\$ 267,598</u>	<u>\$ (646,972)</u>
Assets acquired (liabilities assumed) in the acquisition of Core Business Bank (at fair value)		
Investment securities	\$ -	\$ 14,118,400
Loans receivable	-	33,221,400
Premises and equipment	-	404,700
Core deposit intangible	-	223,000
Other assets	-	604,400
Deposits	-	(47,225,000)
Accrued expenses and other liabilities	-	(42,200)
Equity	-	(8,425,000)

Note 1 - Organization and Summary of Significant Accounting Policies

Nature of operations - Puget Sound Bank (the Bank) provides a full range of banking services to individual and corporate customers through its sole office in Bellevue, Washington. Its primary deposit products are checking, money market, savings, and term certificate accounts, and its primary lending products are commercial loans, commercial real estate loans, and consumer loans. The Bank is subject to significant competition from other financial institutions. The Bank is also subject to the regulations of certain federal and state of Washington agencies and undergoes periodic examinations by those regulatory authorities.

On March 20, 2013, the Bank entered into a definitive purchase and assumption agreement with Core Business Bank to purchase 100% of Core Business Bank (Core). Core was a full-service institution that operated one branch in Bellevue, Washington. Core Business Bank merged with and into Puget Sound Bank and the transaction was completed on June 14, 2013, with Puget Sound Bank as the surviving institution. The Acquisition is meant to strategically build stockholder value through expanding its customer base (Note 2).

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

Cash and due from banks - 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 three months 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 banks - Interest-bearing deposits in banks include interest-bearing deposits and certificates of deposit in federally insured financial institutions located throughout the United States, and the Federal Reserve Bank. At times, these deposits may exceed the current Federal Deposit Insurance Corporation (FDIC)-insured amount of \$250,000.

Restricted assets - Federal Reserve Board regulations generally require maintenance of certain minimum reserve balances on deposit with the Federal Reserve Bank or another institution in a pass-through relationship. These requirements are generally based on size and other factors. At December 31, 2014 and 2013, the Bank's required reserve was \$8,596,000 and \$5,564,000, respectively.

Investment securities - Investment securities are classified into one of three categories: (1) held-to-maturity, (2) available-for-sale, or (3) trading. The Bank had no trading or held-to-maturity securities at December 31, 2014 or 2013. Investment securities are categorized as held-to-maturity when the Bank has the positive intent and ability to hold those securities to maturity. Securities that are held-to-maturity are carried at amortized cost. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

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

Investment securities categorized as available-for-sale are generally held for investment purposes (to maturity), although unanticipated future events may result in the sale of some securities. Available-for-sale securities are recorded at estimated fair value, with unrealized gains or losses reported in accumulated other comprehensive income, net of tax. Realized gains or losses on sales are based on the net proceeds and the adjusted carrying amount of securities sold, using the specific identification method, and are included in earnings.

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

Federal Home Loan Bank stock - The Bank's investment in Federal Home Loan Bank (FHLB) of Seattle stock is carried at par value (\$100 per share), which reasonably approximates its fair value. 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 may request redemption at par value of any stock in excess of the amount the Bank is required to hold. Stock redemptions are at the discretion of the FHLB.

The Bank had \$395,700 and \$388,600 in shares of FHLB stock at December 31, 2014 and 2013, respectively. FHLB stock is carried at par and does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions, and can only be purchased and redeemed at par.

The Bank evaluates FHLB stock for impairment. The determination of whether these investments are impaired is based on the Bank's assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted; (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB; and (4) the liquidity position of the FHLB.

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

The Bank has determined there is not an other-than-temporary impairment on the FHLB stock investment as of December 31, 2014 or 2013.

Pacific Coast Bankers' Bank stock - Pacific Coast Bankers' Bank (PCBB) stock represents an investment by the Bank in the capital stock of PCBB of \$190,000 at December 31, 2014 and 2013, and is carried at par value (\$47.50), which reasonably approximates fair value.

Loans held-for-sale - Loans originated and intended for sale in secondary markets are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. There were no loans held-for-sale at December 31, 2014 or 2013.

Loans - Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding principal adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in process of collection. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash basis or cost-recovery method until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably ensured.

Loan sales recognition - The Bank recognizes a transaction as a sale when the transferred portion (or portions) and any portion that continues to be held by the transferor is a participating interest. Participating interest is defined as a portion of a financial asset that (a) conveys proportionate ownership rights with equal priority to each participating interest holder, (b) involves no recourse (other than standard representations and warranties), and (c) does not entitle any participating interest holder to receive cash before any other participating interest holder. The transfer of the participating interest (or participating interests) must also meet the conditions for surrender of control.

To determine the gain or loss on sale of loans, the Bank's investment in the loan is allocated among the retained portion of the loan, the servicing retained, and the sold portion of the loan, based on the relative fair market value of each portion. The gain or loss on the sold portion of the loan is based on the difference between the sale proceeds and the allocated investment in the sold portion of the loan.

The Bank retains the servicing on the sold guaranteed portion of Small Business Administration (SBA) loans. The Bank receives a fee for servicing the loan.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 1 - Organization 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, if practicable. To determine the fair value of servicing rights, management uses a valuation model that calculates the present value of future cash flows. The Bank has chosen to amortize the remaining servicing asset in proportion to, and over the period of, estimated net servicing income or net servicing loss. Originated servicing rights are recorded when SBA loans are originated and subsequently sold with the servicing rights retained.

Fair value is based on market prices for comparable mortgage servicing contracts, when available, or, alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, and default rates and losses. Impairment exists when the carrying amount of the SBA servicing asset exceeds the estimated fair value. Impairment is evaluated based on stratifying the underlying SBA servicing asset by date of origination and term. Any impairment, if temporary, is reported as a valuation allowance, to the extent that the carrying value exceeds the estimated fair value. The SBA servicing asset is not material at December 31, 2014 and 2013.

Allowance for loan losses - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral, if the loan is collateral-dependent.

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

A troubled debt restructuring 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. The loan terms that have been modified or restructured due to the borrower's financial difficulty include, but are not limited to, a reduction in the stated interest rate; an extension of the maturity; an interest rate below market; a reduction in the face amount of the debt; a reduction in the accrued interest; or extension, deferral, renewal, or rewrite of the original loan terms.

Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are subject to a restructuring agreement due to financial difficulties of the borrower.

Transfers of financial assets - Transfers of an entire financial asset, a group of financial assets, or a participating interest in an entire financial asset are accounted for as sales when control over the assets has been relinquished. 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.

Leaseholds and equipment - Bank leaseholds and equipment are stated at cost less accumulated depreciation. Leaseholds and equipment are depreciated or amortized using the straight-line method over the estimated useful lives of the related assets, which range from 1 to 8 years. Total depreciation and amortization expense was \$306,146 and \$208,957 for the years ended December 31, 2014 and 2013, respectively.

Bank-owned life insurance - The carrying amount of bank-owned life insurance approximates its fair value, net of any surrender charges.

Foreclosed assets - Assets acquired through, or in lieu of, loan foreclosure are held-for-sale and are initially recorded at the lower of cost or estimated fair value at the date of foreclosure. Losses arising from the acquisition of property, in full or partial satisfaction of loans, are charged to the allowance for loan losses. Subsequent to foreclosure, assets are carried at the lower of fair value less cost to sell and any valuation allowance is recorded through noninterest expense. Operating costs after acquisition are expensed. There were no foreclosed assets at December 31, 2014 or 2013.

Goodwill and other intangibles - Intangible assets consist of goodwill and other intangibles acquired in business combinations. Goodwill and intangible assets with indefinite useful lives are not amortized. Intangible assets with definite useful lives are amortized to their estimated residual values over their respective estimated useful lives, and are also reviewed for impairment. Amortization of intangible assets is included in other noninterest expense in the statements of income.

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NOTES TO FINANCIAL STATEMENTS

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

The Bank performs a goodwill impairment analysis on an annual basis as of September 30. Additionally, the Bank will perform a goodwill impairment evaluation on an interim basis when events or circumstances indicate impairment potentially exists.

On at least an annual basis, the Bank assesses the qualitative factors to determine whether it is necessary to perform a quantitative impairment test. The quantitative impairment test involves a two-step process. The first step compares the fair value of a reporting unit to its carrying value. If the reporting unit's fair value is less than its carrying value, the Bank would be required to proceed to the second step. In the second step, the Bank calculates the implied fair value of the reporting unit's goodwill. The implied fair value of goodwill is determined in the same manner as goodwill recognized in a business combination. The estimated fair value of the Bank is allocated to all of the Bank's assets and liabilities, including any unrecognized identifiable intangible assets, as if the Bank had been acquired in a business combination and the estimated fair value of the reporting unit is the price paid to acquire it. The allocation process is performed only for the purposes of determining the amount of goodwill impairment. No assets or liabilities are written up or down, nor are any additional unrecognized identifiable intangible assets recorded as a part of this process. Any excess of the estimated purchase price over the fair value of the reporting unit's net assets represents the implied fair value of goodwill. If the carrying amount of the goodwill is greater than the implied fair value of that goodwill, an impairment loss would be recognized as a charge to earnings in an amount equal to that excess.

Income taxes - The Bank records its provision for income tax 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 recognition of a deferred tax asset is based on more-likely-than-not recognition criteria.

Financial instruments - In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Advertising and marketing costs - The Bank expenses advertising and marketing costs as they are incurred. Total advertising and marketing expenses were \$48,944 and \$14,940 for the years ended December 31, 2014 and 2013, respectively.

Comprehensive income - Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. In addition to net income, other components of comprehensive income include the net of tax effect of changes in the net unrealized gains and losses on securities available-for-sale.

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

Stock-based compensation plans - The Bank has a stock-based compensation plan (Note 12). Stock-based compensation cost is recognized at the grant-date fair value and is based on awards that are ultimately expected to vest. The cost is recognized over the period during which an employee is required to provide services in exchange for the award. The tax benefit resulting from tax deductions in excess of the compensation cost recognized is classified as a financing activity in the statements of cash flows. In 2014, there was a windfall adjustment of 84,479. In 2013, there was no benefit resulting from deductions in excess of the compensation cost.

Earnings per common share - Earnings per common share (EPS) are computed using the two-class method. Basic EPS are computed by dividing net income allocated to common shares by the weighted-average number of common shares outstanding for the period, excluding any participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive nonforfeitable dividends at the same rate as the holders of the Bank's common stock. Diluted EPS are computed by dividing net income allocated to common shares adjusted for reallocation of undistributed earnings of unvested restricted shares by the weighted-average number of common shares determined for the basic EPS plus the dilutive effect of common stock equivalents using the treasury stock method based on the average market price for the period. Some stock options are anti-dilutive and, therefore, are not included in the calculation of diluted EPS.

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 these estimates.

Segment information - The Bank's activities are considered to be a single industry segment for financial reporting purposes. The Bank is engaged in the business of attracting deposits from the general public and providing lending services. Substantially all income is derived from a diverse base of commercial and consumer lending activities and investments.

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 17, 2015, which is the date the financial statements were issued.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 2 - Business Combination

On June 14, 2013, Core 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 \$8,425,000. The Bank paid 80% through issuance of Puget Sound Bank stock totaling \$6,739,343 and 20% in cash totaling \$1,685,657. 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 for up to one year after the closing date of the Acquisition. Upon completion of the Acquisition, Core's branch was moved into the Bank's sole location. The application of the acquisition method of accounting resulted in \$1,995,000 of goodwill and a core deposit intangible of \$223,000. The entire amount of the goodwill is tax deductible over a period of 15 years. The core deposit intangible is being amortized over a period of 10 years.

The operations of Core are included in the Bank's operating results from June 14, 2013, and added revenue of approximately \$1,133,000 and expense of \$795,000 and net income of \$338,000, net of tax for the year ended December 31, 2013. Core's results of operations prior to the Acquisition are not included in the Bank's operating results. Acquisition-related expenses of \$774,000 have been incurred in connection with the acquisition of Core related to professional and other related expenses, within their natural classification on the statements of income.

Goodwill represents the excess of the fair value of the acquired equity over the estimated fair value of the net assets acquired and liabilities assumed, and results from expected synergies of the Acquisition.

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

Assets	
Cash and cash equivalents	\$ 5,125,300
Investment securities	14,118,400
Loans receivable	33,221,400
Premises and equipment	404,700
Core deposit intangible	223,000
Other assets	604,400
	<hr/>
Total assets acquired	53,697,200
Liabilities	
Deposits	47,225,000
Accrued expenses and other liabilities	42,200
	<hr/>
Total liabilities assumed	47,267,200
	<hr/>
Net assets acquired	6,430,000
	<hr/>
Goodwill	1,995,000
	<hr/>
Fair value of the acquired entity	<u><u>\$ 8,425,000</u></u>

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 2 - Business Combination (continued)

Summaries of the net assets acquired and the estimated fair value adjustments and resulting goodwill recognized from the Acquisition were as follows:

Fair value of acquired equity	\$ 8,425,000
Cost basis of net assets on Acquisition date	(7,043,000)
Fair value adjustments recorded	
Prepaid expenses	103,000
Investment securities	92,000
Loans receivable	650,000
Premises and equipment	24,000
Core deposit intangible	(223,000)
Deposits	27,000
Other liabilities	(60,000)
	<u> </u>
Goodwill recognized from the Acquisition	<u><u>\$ 1,995,000</u></u>

Note 3 - Investment Securities

Amortized cost and approximate fair values of investment securities are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2014				
Available-for-sale securities				
U.S. government agencies	\$ 6,893,836	\$ 7,939	\$ 28,222	\$ 6,873,553
Mortgage-backed securities	15,316,563	121,064	87,944	15,349,683
Collateralized mortgage obligations	7,415,578	25,360	60,139	7,380,799
Municipal securities	3,453,749	12,145	21,752	3,444,142
SBA-related securities	6,561,222	-	163,693	6,397,529
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total available-for-sale securities	<u><u>\$ 39,640,948</u></u>	<u><u>\$ 166,508</u></u>	<u><u>\$ 361,750</u></u>	<u><u>\$ 39,445,706</u></u>
December 31, 2013				
Available-for-sale securities				
U.S. government agencies	\$ 6,696,062	\$ 29,314	\$ 106,876	\$ 6,618,500
Mortgage-backed securities	21,292,657	120,965	400,665	21,012,957
Municipal securities	2,075,277	2,098	84,906	1,992,469
SBA-related securities	8,482,672	2,513	180,673	8,304,512
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total available-for-sale securities	<u><u>\$ 38,546,668</u></u>	<u><u>\$ 154,890</u></u>	<u><u>\$ 773,120</u></u>	<u><u>\$ 37,928,438</u></u>

PUGET SOUND BANK **NOTES TO FINANCIAL STATEMENTS**

Note 3 - Investment Securities (continued)

The amortized cost and estimated fair value of investment securities at December 31, 2014, by contractual or expected maturity, are shown below. Expected maturities will differ from contractual maturities, because issuers of certain debt securities have the right to call or prepay their obligations without penalty.

	Available-for-Sale	
	Amortized Cost	Estimated Fair Value
Due in 1 year or less	\$ 199,030	\$ 201,594
Due in 1 to 5 years	10,598,261	10,584,059
Due in 5 to 10 years	11,731,859	11,759,088
Due in over 10 years	17,111,798	16,900,965
	<u>\$ 39,640,948</u>	<u>\$ 39,445,706</u>

Proceeds from the sale of securities were \$651,321 in 2014. Gross realized gains totaled \$4,423 and gross realized losses were \$0 from the sales of securities in 2014. Proceeds from the sale of securities were \$2,261,937 in 2013. Gross realized gains totaled \$10,482 and gross realized losses were \$0 from the sales of securities in 2013.

At December 31, 2014 and 2013, the Bank has also pledged securities with a carrying amount of \$28,280,704 and \$24,992,105, respectively, to collateralize borrowings (Note 7).

Information pertaining to securities with gross unrealized losses at December 31, 2014 and 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less Than 12 Months		Over 12 Months		Total
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2014					
Available-for-sale securities					
U.S. government agencies	\$ 281	\$ 1,006,430	\$ 27,941	\$ 2,967,250	\$ 28,222
Mortgage-backed securities	12,721	2,877,901	75,223	5,064,488	87,944
Collateralized mortgage obligations	3,606	2,183,825	56,533	2,114,238	60,139
Municipal securities	4,313	1,020,969	17,439	882,115	21,752
SBA-related securities	8,434	847,890	155,259	5,549,639	163,693
	<u>\$ 29,355</u>	<u>\$ 7,937,015</u>	<u>\$ 332,395</u>	<u>\$ 16,577,730</u>	<u>\$ 361,750</u>
December 31, 2013					
Available-for-sale securities					
U.S. government agencies	\$ 106,876	\$ 3,874,690	\$ -	\$ -	\$ 106,876
Mortgage-backed securities	400,665	13,918,264	-	-	400,665
Municipal securities	46,507	1,127,241	38,399	594,737	84,906
SBA-related securities	180,673	7,820,919	-	-	180,673
	<u>\$ 734,721</u>	<u>\$ 26,741,114</u>	<u>\$ 38,399</u>	<u>\$ 594,737</u>	<u>\$ 773,120</u>

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 3 - Investment Securities (continued)

Certain investment securities shown in the table currently have fair values less than amortized cost and, therefore, contain unrealized losses. The Bank has evaluated these securities and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase. The decline in value is not related to any Bank- or industry-specific event. There are 41 investment securities with unrealized losses at December 31, 2014, and 46 with unrealized losses at December 31, 2013. The Bank anticipates full recovery of amortized cost with respect to these securities at maturity or sooner in the event of a more favorable market interest rate environment. Because management does not intend to sell and will not be required to sell these securities in the near term, no declines are deemed to be other than temporary.

Note 4 - Loans

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

	<u>2014</u>	<u>2013</u>
Commercial real estate		
Owner-occupied	\$ 61,207,824	\$ 54,329,149
Nonowner-occupied	61,659,322	59,261,778
Construction and land development	29,146,067	12,865,488
Commercial	132,614,970	126,564,956
Consumer		
Real estate	27,740,031	19,571,823
Other	<u>3,154,291</u>	<u>2,839,733</u>
	315,522,505	275,432,927
Deferred loan fees	(507,213)	(522,251)
Allowance for loan losses	<u>(4,013,425)</u>	<u>(3,538,195)</u>
	311,001,867	271,372,481
Total loans, net	<u><u>\$ 311,001,867</u></u>	<u><u>\$ 271,372,481</u></u>

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

Contractual maturities of loans at December 31, 2014, are shown below. Actual maturities may differ from contractual maturities because individual borrowers may have the right to prepay loans with or without prepayment penalties.

	Within 1 Year	1-5 Years	After 5 Years	Totals
Commercial real estate				
Owner-occupied	\$ 9,994,108	\$ 17,120,061	\$ 34,093,655	\$ 61,207,824
Nonowner-occupied	9,972,541	41,286,703	10,400,078	61,659,322
Construction and land development	23,700,720	5,445,347	-	29,146,067
Commercial	71,388,077	45,440,146	15,786,747	132,614,970
Consumer				
Real estate	23,873,768	3,866,263	-	27,740,031
Other	1,683,835	1,470,456	-	3,154,291
	<u>\$ 140,613,049</u>	<u>\$ 114,628,976</u>	<u>\$ 60,280,480</u>	<u>\$ 315,522,505</u>
		1-5 Years	After 5 Years	
Loans maturing after 1 year with				
Fixed rates		\$ 73,588,786	\$ 34,813,390	
Variable rates		41,040,190	25,467,090	
		<u>\$ 114,628,976</u>	<u>\$ 60,280,480</u>	

The Bank maintains an allowance for loan and lease losses (ALLL) to absorb losses inherent in the loan portfolio. The size of the ALLL is determined through quarterly assessments of the probable estimated losses in the loan portfolio. The Bank's methodology for making such assessments and determining the adequacy of the ALLL includes the following key elements:

1. General valuation allowance consistent with the *Contingencies* topic of the FASB ASC.
2. Classified loss reserves on specific relationships. Specific allowances for identified problem loans are determined in accordance with the *Receivables* topic of the FASB ASC.
3. The unallocated allowance provides for other factors inherent in the Bank's loan portfolio that may not have been contemplated in the general and specific components of the allowance. This unallocated amount generally comprises less than 20% of the allowance. The unallocated amount is reviewed quarterly based on trends in credit losses, the results of credit reviews, and overall economic trends.

Note 4 - Loans (continued)

The general valuation allowance is systematically calculated quarterly using quantitative and qualitative information about specific loan classes. The minimum required level in which an entity develops a systematic methodology to determine its allowance for loan and lease losses is at the segment level. However, the Bank's systematic methodology in determining its allowance for loan and lease losses is prepared at the loan level, which is more detailed than the segment level. The quantitative information uses historical losses from specific loan classes and incorporates the loan's risk rating migration from origination to the point of loss. A loan's risk rating is primarily determined based upon the borrower's ability to fulfill its debt obligation from a cash flow perspective. In the event there is financial deterioration of the borrower, the borrower's other sources of income or repayment are also considered, including recent appraisal values for collateral-dependent loans. The qualitative information takes into account general economic and business conditions affecting the Bank's marketplace, seasoning of the loan portfolio, duration of the business cycle, etc., to ensure its methodologies reflect the current economic environment and other factors, because using historical loss information exclusively may not give an accurate estimate of inherent losses within the Bank's loan portfolio.

The specific valuation allowance is a reserve for each loan determined to be impaired when the value of the impaired loan is less than its recorded investment. The Bank measures the impairment based on the discounted expected future cash flows, observable market price, or the fair value of the collateral, if the loan is collateral-dependent or if foreclosure is probable. The specific reserve for each loan is equal to the difference between the recorded investment in the loan and its determined impairment value.

The ALLL is increased by provisions for loan and lease losses charged to expense, and is reduced by loans charged off, net of recoveries. Although the Bank's management believes the best information available is used to determine the ALLL, changes in market conditions could result in adjustments to the ALLL, affecting net income if circumstances differ from the assumptions used in determining the ALLL.

Adjustments to the percentages of the ALLL allocated to loan categories are made based on trends with respect to delinquencies and problem loans within each pool of loans. The Bank reviews the ALLL quantitative and qualitative methodology on a quarterly basis and makes adjustments when appropriate. The Bank strives to maintain a conservative approach to credit quality and will continue to prudently add to the ALLL as necessary to maintain adequate reserves. The Bank carefully monitors the loan portfolio and continues to emphasize the importance of credit quality while continuously strengthening loan monitoring systems and controls.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

The allowance for loan losses and the recorded investment in loans for the years ended December 31 and changes during the years are as follows:

	Beginning Balance	Provision (Recapture) for Loan Losses	Charge-offs	Recoveries	Ending Balance
2014					
Commercial	\$ 1,271,294	\$ 173,470	\$ -	\$ 7,699	\$ 1,452,463
Commercial real estate	878,702	41,043	-	-	919,745
Construction and land development	365,599	361,925	(145,026)	-	582,498
Consumer	246,263	103,645	-	-	349,908
Unallocated	776,337	(67,526)	-	-	708,811
	<u>\$ 3,538,195</u>	<u>\$ 612,557</u>	<u>\$ (145,026)</u>	<u>\$ 7,699</u>	<u>\$ 4,013,425</u>
2013					
Commercial	\$ 1,578,886	\$ (433,670)	\$ -	\$ 126,078	\$ 1,271,294
Commercial real estate	861,495	17,207	-	-	878,702
Construction and land development	435,431	221,658	(291,490)	-	365,599
Consumer	152,725	71,673	-	21,865	246,263
Unallocated	212,064	564,273	-	-	776,337
	<u>\$ 3,240,601</u>	<u>\$ 441,141</u>	<u>\$ (291,490)</u>	<u>\$ 147,943</u>	<u>\$ 3,538,195</u>

The following presents the activity in the allowance for loan losses and impairment method by segment for the years ended December 31:

	Allowance			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
2014						
Commercial	\$ 1,452,463	\$ -	\$ 1,452,463	\$ 132,614,970	\$ 46,177	\$ 132,568,793
Commercial real estate	919,745	-	919,745	122,867,146	-	122,867,146
Construction and land development	582,498	107,443	475,055	29,146,067	537,216	28,608,851
Consumer	349,908	-	349,908	30,894,322	-	30,894,322
Unallocated	708,811	-	708,811	-	-	-
	<u>\$ 4,013,425</u>	<u>\$ 107,443</u>	<u>\$ 3,905,982</u>	<u>\$ 315,522,505</u>	<u>\$ 583,393</u>	<u>\$ 314,939,112</u>
2013						
Commercial	\$ 1,271,294	\$ -	\$ 1,271,294	\$ 126,564,956	\$ 46,177	\$ 126,518,779
Commercial real estate	878,702	-	878,702	113,590,927	-	113,590,927
Construction and land development	365,599	53,120	312,479	12,865,488	692,221	12,173,267
Consumer	246,263	-	246,263	22,411,556	-	22,411,556
Unallocated	776,337	-	776,337	-	-	-
	<u>\$ 3,538,195</u>	<u>\$ 53,120</u>	<u>\$ 3,485,075</u>	<u>\$ 275,432,927</u>	<u>\$ 738,398</u>	<u>\$ 274,694,529</u>

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

The following table shows impaired loans for the years ended December 31:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Investment in Impaired Loans</u>	<u>Interest Income Recognized</u>
2014					
With no related allowance recorded					
Commercial	\$ 46,177	\$ 602,443	\$ -	\$ 46,177	\$ -
With an allowance recorded					
Construction and land development	537,216	1,616,162	107,443	651,154	-
Total					
Commercial	46,177	602,443	-	46,177	-
Construction and land development	537,216	1,616,162	107,443	651,154	-
2013					
With no related allowance recorded					
Commercial	\$ 46,177	\$ 602,443	\$ -	\$ 86,309	\$ -
With an allowance recorded					
Construction and land development	692,222	1,471,135	53,120	692,222	-
Total					
Commercial	46,177	602,443	-	86,309	-
Construction and land development	692,222	1,471,135	53,120	692,222	-

When the Bank classifies problem assets as either 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, 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 State Department of Financial Institutions, which can require the establishment of additional loss allowances.

Loan risk grades are used by the Bank to identify and track potential problem loans that do not rise to the levels described for substandard, doubtful, or loss. The grades for watch and special mention are 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.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

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

Credit risk profile by internally assigned grade

	Pass	Special Mention	Substandard	Doubtful	Total
2014					
Commercial real estate					
Owner-occupied	\$ 59,480,691	\$ -	\$ 1,727,133	\$ -	\$ 61,207,824
Nonowner-occupied	61,659,322	-	-	-	61,659,322
Construction and land development	28,608,851	-	537,216	-	29,146,067
Commercial	131,781,998	-	832,972	-	132,614,970
Consumer					
Real estate	27,740,031	-	-	-	27,740,031
Other	3,154,291	-	-	-	3,154,291
	<u>\$ 312,425,184</u>	<u>\$ -</u>	<u>\$ 3,097,321</u>	<u>\$ -</u>	<u>\$ 315,522,505</u>
2013					
Commercial real estate					
Owner-occupied	\$ 52,569,529	\$ -	\$ 1,759,620	\$ -	\$ 54,329,149
Nonowner-occupied	59,063,723	198,055	-	-	59,261,778
Construction and land development	12,173,267	-	692,221	-	12,865,488
Commercial	124,370,303	1,784,331	410,322	-	126,564,956
Consumer					
Real estate	19,571,823	-	-	-	19,571,823
Other	2,839,733	-	-	-	2,839,733
	<u>\$ 270,588,378</u>	<u>\$ 1,982,386</u>	<u>\$ 2,862,163</u>	<u>\$ -</u>	<u>\$ 275,432,927</u>

Credit risk profile based on payment activity

	Performing	Nonperforming	Total
2014			
Commercial real estate			
Owner-occupied	\$ 61,207,824	\$ -	\$ 61,207,824
Nonowner-occupied	61,659,322	-	61,659,322
Construction and land development	28,608,851	537,216	29,146,067
Commercial	132,568,793	46,177	132,614,970
Consumer			
Real estate	27,740,031	-	27,740,031
Other	3,154,291	-	3,154,291
	<u>\$ 314,939,112</u>	<u>\$ 583,393</u>	<u>\$ 315,522,505</u>
2013			
Commercial real estate			
Owner-occupied	\$ 54,329,149	\$ -	\$ 54,329,149
Nonowner-occupied	59,261,778	-	59,261,778
Construction and land development	12,173,266	692,222	12,865,488
Commercial	126,518,779	46,177	126,564,956
Consumer			
Real estate	19,571,823	-	19,571,823
Other	2,839,733	-	2,839,733
	<u>\$ 274,694,528</u>	<u>\$ 738,399</u>	<u>\$ 275,432,927</u>

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

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

	30 - 59 Days Past Due	60 - 90 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Nonaccrual Status
2014							
Commercial real estate							
Owner-occupied	\$ 1,727,133	\$ -	\$ -	\$ 1,727,133	\$ 59,480,691	\$ 61,207,824	\$ -
Non-owner occupied	-	-	-	-	61,659,322	61,659,322	-
Construction and land development	-	-	537,216	537,216	28,608,851	29,146,067	537,216
Commercial	-	-	46,177	46,177	132,568,793	132,614,970	46,177
Consumer						-	
Real estate	-	-	-	-	27,740,031	27,740,031	-
Other	-	-	-	-	3,154,291	3,154,291	-
	<u>\$ 1,727,133</u>	<u>\$ -</u>	<u>\$ 583,393</u>	<u>\$ 2,310,526</u>	<u>\$ 313,211,979</u>	<u>\$ 315,522,505</u>	<u>\$ 583,393</u>
2013							
Commercial real estate							
Owner-occupied	\$ -	\$ -	\$ -	\$ -	\$ 54,329,149	\$ 54,329,149	\$ -
Non-owner occupied	-	-	-	-	59,261,778	59,261,778	-
Construction and land development	-	-	692,222	692,222	12,173,266	12,865,488	692,222
Commercial	-	-	46,177	46,177	126,518,779	126,564,956	46,177
Consumer							
Real estate	-	-	-	-	19,571,823	19,571,823	-
Other	-	-	-	-	2,839,733	2,839,733	-
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 738,399</u>	<u>\$ 738,399</u>	<u>\$ 274,694,528</u>	<u>\$ 275,432,927</u>	<u>\$ 738,399</u>

There were no loans with a balance more than 90 days past due and still accruing at December 31, 2014 or 2013.

Loans classified as troubled debt restructurings totaled \$551,674 and \$751,042 at December 31, 2014 and 2013, respectively. 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. The modifications granted can generally be described in the following categories:

Rate modification - A modification in which the interest rate is changed.

Term modification - A modification in which the maturity date, timing of payments, or frequency of payments is changed.

Payment modification - A modification in which the dollar amount of the payment is changed. Interest-only modifications in which a loan is converted to interest-only payments for a period of time are included in this category.

Combination modification - Any other type of modification, including the use of multiple categories above.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans (continued)

Upon identifying those receivables as troubled debt restructurings, the Bank identified them as impaired for purposes of determining the allowance for loan losses. This requires the loans to be evaluated individually for impairment, generally based on the expected cash flows under the new terms discounted at the loans' original effective interest rates, or, if the loan is deemed to be collateral-dependent, the impairment is based on the fair value of the collateral less estimated selling costs. For troubled debt restructured loans that subsequently default, the method of determining impairment is generally the fair value of the collateral less estimated selling costs.

There were no newly restructured loans during the years ended December 31, 2014 or 2013.

The Bank had no commitments to extend additional credit to borrowers owing receivables whose terms have been modified in troubled debt restructurings.

Note 5 - Leaseholds and Equipment

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

	<u>2014</u>	<u>2013</u>
Leasehold improvements	\$ 508,416	\$ 505,479
Furniture, fixtures, and office equipment	<u>1,104,487</u>	<u>1,064,383</u>
	1,612,903	1,569,862
Less accumulated depreciation and amortization	<u>(1,226,756)</u>	<u>(920,610)</u>
	<u><u>\$ 386,147</u></u>	<u><u>\$ 649,252</u></u>

Note 6 - Deposits

Deposits as of December 31 consisted of the following:

	<u>2014</u>	<u>2013</u>
Savings accounts	\$ 244,753	\$ 233,958
Certificates of deposit	26,852,167	25,932,015
Demand accounts		
Noninterest-bearing	177,372,542	122,026,706
Interest-bearing	24,040,550	24,649,875
Money market accounts	<u>108,082,530</u>	<u>107,924,375</u>
	<u><u>\$ 336,592,542</u></u>	<u><u>\$ 280,766,929</u></u>

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 6 - Deposits (continued)

At December 31, 2014, scheduled maturities of certificates of deposit are as follows:

2015	\$ 20,876,802
2016	580,436
2017	<u>5,394,929</u>
	<u><u>\$ 26,852,167</u></u>

The Bank takes in funds from customers on deposit. These funds are used to lend to borrowers and support operations. The Bank would maintain liquidity through available borrowing lines, brokered deposits, and other liquid assets to fulfill deposits if customers were to request withdrawal.

The Bank had \$10,143,846 and \$4,711,737 of certificates of deposit that met or exceeded the \$250,000 federally insured limit at December 31, 2014 and 2013, respectively.

Note 7 - Borrowings and Credit Arrangements

The Bank is a member of the FHLB of Seattle and, as such, has a committed credit line up to 20% of total assets, subject to sufficient collateral to support the advances. At December 31, 2014, the principal balance of loans pledged as collateral was \$70,541,126, and the amount available to borrow totaled \$41,592,191. At December 31, 2014, the carrying amount of securities pledged as collateral of \$28,280,704 supported additional borrowing capacity of \$26,818,602. Borrowings generally provide for interest at the then-current published rates. As of December 31, 2013, the Bank had short-term FHLB advances outstanding with a total principal balance of \$12,000,000 at an adjustable rate of .23%. The FHLB advances were repaid on January 6, 2014.

The Bank has a committed line of credit through the Federal Reserve Bank of San Francisco. Borrowings generally provide for interest at the then-current published rates. At December 31, 2014, the principal balance of loans pledged as collateral was \$103,364,029, and the amount available to borrow totaled \$80,655,341. There were no outstanding balances under these credit arrangements at December 31, 2014 and 2013.

At December 31, 2014, the Bank has line-of-credit agreements with unaffiliated banks totaling approximately \$34,000,000. Such lines generally provide for interest at the lending bank's federal funds rate or other money market rates. These lines are not committed and are still subject to approval by the unaffiliated banks prior to funding. There were no borrowings outstanding or compensating balance requirements under these credit arrangements at December 31, 2014 and 2013.

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 8 - Income Taxes

The components of the provision for income taxes are as follows at December 31:

	<u>2014</u>	<u>2013</u>
Current	\$ 1,954,561	\$ 1,425,498
Deferred	<u>(475,000)</u>	<u>(208,000)</u>
Total	<u><u>\$ 1,479,561</u></u>	<u><u>\$ 1,217,498</u></u>

A reconciliation of the tax provision based on statutory corporate tax rates, estimated to be 34%, on pre-tax income and the provision shown in the accompanying statements of income for the years ended December 31 is summarized as follows:

	<u>2014</u>		<u>2013</u>	
	<u>Amount</u>	<u>Percent of Pre-Tax Income</u>	<u>Amount</u>	<u>Percent of Pre-Tax Income</u>
Income taxes at computed statutory rates	\$ 1,599,016	34.0%	\$ 1,149,859	34.0%
Permanent differences and other, net	<u>(119,455)</u>	<u>(2.5)</u>	<u>67,639</u>	<u>2.0</u>
Total	<u><u>\$ 1,479,561</u></u>	<u><u>31.5%</u></u>	<u><u>\$ 1,217,498</u></u>	<u><u>36.0%</u></u>

The nature and components of the Bank's net deferred tax assets established at an estimated tax rate of 34% at December 31 are as follows:

	<u>2014</u>	<u>2013</u>
Allowance for loan losses	\$ 1,187,000	\$ 1,017,000
Organization expenditures	62,000	58,000
Equity compensation	81,000	103,000
Deferred compensation	222,000	167,000
Unrealized loss on securities	66,000	211,000
Property and equipment depreciation	10,000	-
Other	<u>310,000</u>	<u>204,000</u>
Deferred tax asset	<u>1,938,000</u>	<u>1,760,000</u>
Deferred loan costs	193,000	157,000
Property and equipment depreciation	<u>-</u>	<u>188,000</u>
Deferred tax liability	<u>193,000</u>	<u>345,000</u>
Net deferred tax asset	<u><u>\$ 1,745,000</u></u>	<u><u>\$ 1,415,000</u></u>

Note 8 - Income Taxes (continued)

At December 31, 2014, the Bank had unamortized pre-opening expenditures of approximately \$206,000 (for tax reporting purposes), which can be used to offset future federal income taxes. These expenditures are amortizing at a rate of approximately \$39,000 per year.

The Bank applies the provisions of FASB ASC 740 that relate to accounting for uncertainty in income taxes. The Bank had no unrecognized tax benefits at December 31, 2014 or 2013. The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2014 and 2013, the Bank recognized no interest and penalties. The Bank files income tax returns in the U.S. federal jurisdiction. With few exceptions, the Bank is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2011.

Note 9 - Employee Benefits

The Bank has a 401(k) defined contribution plan for those employees who meet the eligibility requirements set forth in the plan. Eligible employees can contribute up to 100% of compensation, subject to certain limits based on federal tax laws. The Bank makes matching contributions equal to 100%, up to 3% of employee compensation, and 50%, up to the next 2% of employee compensation. Matching contributions vest immediately. The Bank's contribution for the years ended December 31, 2014 and 2013, was \$137,435 and \$118,636, respectively.

The Bank provides deferred compensation to certain members of management. The current agreements provide for an annual accrual plus interest to an account over a 10-year period. The accrual under such agreements was \$161,545 and \$149,244 in 2014 and 2013, respectively. The Bank accrues interest on the liability at 5.5%. The liability accrued for under the agreements as of December 31, 2014, was \$652,203 and is included in other liabilities on the balance sheets.

Note 10 - Stockholders' Equity

Warrants - At December 31, 2014 and 2013, there were warrants outstanding to purchase 90,000 shares of the Bank's common stock at \$10 per share that were issued in connection with the Bank's initial offering. The warrants have a term of 10 years and expire on April 11, 2015.

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

PUGET SOUND BANK **NOTES TO FINANCIAL STATEMENTS**

Note 10 - Stockholders' Equity (continued)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2014, that the Bank meets all capital adequacy requirements to which it is subject.

To be categorized as adequately capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios, as set forth in the following table. Management believes the Bank is well capitalized under the prompt corrective action provisions.

As of December 31, 2014, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios, as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31 are also presented in the table.

	Actual (in 000's)		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2014						
Total capital						
(to risk-weighted assets)	\$ 50,658	14.9%	\$ 27,135	≥ 8.0%	\$ 33,920	≥ 10.0%
Tier I capital						
(to risk-weighted assets)	\$ 46,418	13.7%	\$ 13,568	≥ 4.0%	\$ 20,352	≥ 6.0%
Tier I capital						
(to average assets)	\$ 46,418	12.4%	\$ 15,026	≥ 4.0%	\$ 18,783	≥ 5.0%
As of December 31, 2013						
Total capital						
(to risk-weighted assets)	\$ 46,410	15.5%	\$ 23,995	≥ 8.0%	\$ 29,994	≥ 10.0%
Tier I capital						
(to risk-weighted assets)	\$ 42,664	14.2%	\$ 11,997	≥ 4.0%	\$ 17,996	≥ 6.0%
Tier I capital						
(to average assets)	\$ 42,664	13.1%	\$ 13,038	≥ 4.0%	\$ 16,298	≥ 5.0%

The Federal Reserve and the Federal Deposit Insurance Corporation approved final capital rules in July 2013, that substantially amend the existing capital rules for banks. These new rules reflect, in part, certain standards initially adopted by the Basel Committee on Banking Supervision in December 2010 (which standards are commonly referred to as "Basel III") as well as requirements contemplated by the Dodd-Frank Act.

Note 10 - Stockholders' Equity (continued)

Under the new capital rules, the Bank will be required to meet certain minimum capital requirements that differ from current capital requirements. The rules implement a new capital ratio of common equity Tier 1 capital to risk-weighted assets. Common equity Tier 1 capital generally consists of retained earnings and common stock (subject to certain adjustments) as well as accumulated other comprehensive income (AOCI), except to the extent that the Bank exercises a one-time irrevocable option to exclude certain components of AOCI as of March 31, 2015. The Bank will also be required to establish a "conservation buffer," consisting of a common equity Tier 1 capital amount equal to 2.5% of risk-weighted assets to be phased in by 2019. An institution that does not meet the conservation buffer will be subject to restrictions on certain activities including payment of dividends, stock repurchases, and discretionary bonuses to executive officers.

The prompt corrective action rules are modified to include the common equity Tier 1 capital ratio and to increase the Tier 1 capital ratio requirements for the various thresholds. For example, the requirements for the Bank to be considered well-capitalized under the rules will be a 5.0% leverage ratio, a 6.5% common equity Tier 1 capital ratio, an 8.0% Tier 1 capital ratio, and a 10.0% total capital ratio. To be adequately capitalized, those ratios are 4.0%, 4.5%, 6.0%, and 8.0%, respectively.

The rules modify the manner in which certain capital elements are determined. The rules make changes to the methods of calculating the risk weighting of certain assets, which in turn affect the calculation of the risk-weighted capital ratios. Higher risk weights are assigned to various categories of assets, including commercial real estate loans; credit facilities that finance the acquisition, development, or construction of real property; certain credit or exposures that are 90 days past due or are nonaccrual; securitization exposures; and, in certain cases, mortgage servicing rights and deferred tax assets.

The Bank is required to comply with the new capital rules on January 1, 2015, with a measurement date of March 31, 2015. The conservation buffer will be phased in beginning in 2016, and will take full effect on January 1, 2019. Certain calculations under the rules will also have phase-in periods.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 11 - Earnings Per Common Share

Earnings per common share are summarized in the following table:

	2014	2013
Net income	\$ 3,223,426	\$ 2,164,440
Preferred stock dividends	98,860	98,860
Net income available to common stockholders	<u>\$ 3,124,566</u>	<u>\$ 2,065,580</u>
Basic weighted-average common shares outstanding	2,958,848	2,675,734
Plus common stock options considered outstanding for dilutive purposes (excludes antidilutive options)	<u>134,946</u>	<u>96,844</u>
Diluted weighted-average common shares outstanding	<u>3,093,794</u>	<u>2,772,578</u>
Basic earnings per share	<u>\$ 1.06</u>	<u>\$ 0.77</u>
Diluted earnings per share	<u>\$ 1.01</u>	<u>\$ 0.75</u>

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. There were 0 and 5 anti-dilutive shares outstanding related to options to acquire the Bank's common stock at December 31, 2014 and 2013, respectively.

Note 12 - Stock Purchase Agreement and Option Plan

The stockholders of the Bank approved the 2012 Long-Term Equity Incentive Plan (the Incentive Plan) in May 2012, which permits the grant of incentive stock options, nonqualified stock options, restricted stock grants, and restricted stock units. The Bank believes that such awards better align the interests of its employees and directors with those of its stockholders. The number of shares of common stock awards that may be granted under the Incentive Plan, when added to the number of options granted under the Incentive Plan, shall not exceed 600,000 shares. Restricted stock grants or restricted stock units will be limited to 70% of the share of common stock reserved for issuance under the Incentive Plan. The vesting requirements of these awards are determined by the board of directors and are on an individual basis. The employee must be employed by the Bank at the time of vesting or the award is forfeited. There are 547,814 shares available for grant under the Incentive Plan at December 31, 2014.

Compensation cost recognized for the Incentive Plan was \$195,908 and \$224,158 for December 31, 2014 and 2013, respectively. There was no compensation cost capitalized in 2014 or 2013.

Option awards are generally granted with an exercise price equal to the market price of the Bank's stock at the date of grant; those option awards generally vest and become exercisable in incremental percentages over three and four years of continuous service from the grant date and expire after 10 years. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the plans).

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 12 - Stock Purchase Agreement and Option Plan (continued)

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton valuation model that uses the following assumptions. Expected volatilities are based on historical volatility of the Bank's stock and other factors. The Bank uses historical data and other factors to estimate option exercises and employee terminations because separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is derived from the output of that analysis and represents the period of time that options granted are expected to be outstanding. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant. There were no option grants in 2014 or 2013.

A summary of stock option transactions is presented below:

	Granted Options for Common Stock	Weighted- Average Exercise Price of Shares Under Plan	Weighted- Average Remaining Contractual Term
Outstanding at December 31, 2013	328,416	\$ 10.03	1.44
Granted	-	-	
Exercised	(19,700)	10.00	
Forfeited	(16,800)	10.00	
Outstanding at December 31, 2014	<u>291,916</u>	<u>\$ 10.03</u>	<u>0.44</u>
Options exercisable at December 31, 2014	<u>291,916</u>	<u>\$ 10.03</u>	<u>0.44</u>

The total intrinsic value of options exercised during the years ended December 31, 2014 and 2013, was \$80,414 and \$15,950, respectively.

Restricted stock plan - Restricted shares granted vest on an annual basis over four years. The following table summarizes information about restricted shares outstanding at December 31, 2014:

	Restricted Shares Outstanding	Average Grant-Date Fair Value
Balance, beginning of year	62,312	\$ 11.27
Granted	9,864	13.78
Vested	(26,035)	9.92
Forfeited/expired	(4,715)	12.85
Balance, end of year	<u>41,426</u>	<u>\$ 12.52</u>

As of December 31, 2014, there was \$414,944 of total unrecognized compensation cost related to all stock-based compensation arrangements granted under the plan. That cost is expected to be recognized over a weighted-average period of 2.37 years.

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 13 - Preferred Stock Issuance

On August 11, 2011, the Bank issued a series of preferred stock as part of the United States Department of the Treasury's Small Business Lending Fund (SBLF) Program for gross proceeds of \$9,886,000. The Bank issued 9,866 shares of Series C preferred stock with a price of \$1,000 per share. The redemption price of the SBLF remains \$9,886,000, plus any unpaid dividends.

The preferred stock carries no voting rights and may be redeemed in whole or in part, at any time and from time to time, at the option of the Bank. All redemptions shall be subject to the approval of the FDIC. If the Bank has not redeemed all preferred stock by the tenth anniversary of the issuance, all common stock dividends and repurchases of common stock will be prohibited until all preferred stock has been redeemed or transferred to a third party.

The initial dividend rate can range from 1% to 5%, depending on the percentage change in qualified lending. If lending does not increase in the first 2 years, the dividend rate can increase to 7%. After 4.5 years, the dividend rate will increase to 9% if the Bank has not redeemed the SBLF preferred stock. The Bank's dividend rate was 1% during 2014 and 2013.

Note 14 - Lease Commitments

Operating lease commitments - The Bank leases office premises for its operations and office equipment. The office lease expires in 2020. The office lease requires the Bank to pay its pro rata share of building operating expenses. As a result of the Acquisition, the Bank also leases space in two different Bellevue, Washington, buildings. The space under each of the two acquired leases is subleased as of December 31, 2013, of which one lease expires in 2015 and the other expires in 2017. The annual lease obligations through the initial lease term, for all of the office space and equipment, are as follows:

	<u>As Lessee</u>	<u>As Lessor</u>
2015	\$ 685,057	\$ 257,570
2016	546,174	100,819
2017	707,941	77,330
2018	637,056	-
2019	637,056	-
Thereafter	637,056	-
	<u>\$ 3,850,340</u>	<u>\$ 435,719</u>

Rental expense, including operating expenses, offset by rental income received that was charged to operations was \$541,880 and \$475,537 for the years ended December 31, 2014 and 2013, respectively.

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 15 - Related Party Transactions

Certain directors, executive officers, and principal stockholders are Bank customers and have had banking transactions with the Bank. All loans and commitments included in such transactions were made in compliance with applicable laws on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons and do not involve more than the normal risk of collectibility or present any other unfavorable features. The following summarizes these transactions with directors, executive officers, principal stockholders, and companies with which they are associated at December 31:

	<u>2014</u>	<u>2013</u>
Loans outstanding	\$ 2,486,257	\$ 5,672,054
Adjustments ⁽¹⁾	-	(1,877,911)
New loans	-	995,030
Repayments	<u>(890,124)</u>	<u>(2,302,916)</u>
Loans outstanding	<u>\$ 1,596,133</u>	<u>\$ 2,486,257</u>
Commitments to extend credit	<u>\$ -</u>	<u>\$ -</u>

⁽¹⁾ Director resigned; no longer included in this table.

Deposits to related parties were \$13,254,455 and \$13,238,671 at December 31, 2014 and 2013, respectively.

Note 16 - Significant Group Concentrations of Credit Risk

Most of the Bank's business activity is with customers located within King County, Washington. The Bank originates commercial, real estate, and consumer loans. Generally, loans are secured by accounts receivable, inventory, deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. Although the Bank has a diversified loan portfolio, local economic conditions may affect borrowers' ability to meet the stated repayment terms.

The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers. The Bank, as a matter of policy, does not extend credit in excess of 20% of capital to any single borrower or group of related borrowers.

Note 17 - Commitments and Contingencies

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

PUGET SOUND BANK

NOTES TO FINANCIAL STATEMENTS

Note 17 - Commitments and Contingencies (continued)

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

Commitments to extend credit and financial guarantees - Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank's experience has been that approximately 50% of loan commitments are drawn upon by customers. The Bank evaluates customers' creditworthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank maintains various levels of collateral supporting those commitments for which collateral is deemed necessary.

The Bank has not been required to perform on any financial guarantees. The Bank has not incurred any losses on its commitments in 2014 or 2013.

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

	2014	2013
Commitments to extend credit	\$ 129,113,747	\$ 102,743,016
Standby letters of credit	6,999,038	4,486,253

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

Note 18 - Fair Value of Financial Instruments

Fair value determination - Fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants in the Bank's principal market. The Bank has established and documented its process for determining the fair values of its assets and liabilities, where applicable. 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.

Valuation adjustments, such as those pertaining to counterparty and the Bank's own credit quality and liquidity, may be necessary to ensure that assets and liabilities are recorded at fair value. Credit valuation adjustments are made when market pricing is not indicative of the counterparty's credit quality.

Any changes to valuation methodologies are reviewed by management to ensure that they are relevant and justified. Valuation methodologies are refined as more market-based data becomes available.

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

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

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

Level 3 - Unobservable inputs.

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

Qualitative disclosures of valuation techniques

Available-for-sale securities - Where quoted prices are available in an active market, securities are classified as Level 1. Level 1 instruments include highly liquid government bonds, securities issued by the U.S. Treasury, and exchange-traded equity securities. If quoted prices are not available, management determines fair value using pricing models, quoted prices of similar securities, or discounted cash flows (Level 2). In certain cases where there is limited activity in the market for a particular instrument, assumptions must be made to determine its fair value (Level 3).

PUGET SOUND BANK **NOTES TO FINANCIAL STATEMENTS**

Note 18 - Fair Value of Financial Instruments (continued)

Impaired loans - The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches, including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Assets and liabilities measured at fair value on a recurring basis - Assets and liabilities are considered to be fair valued on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly, or quarterly). The following table shows the Bank's assets and liabilities measured at fair value on a recurring basis:

	Level 1	Level 2	Level 3	Total
2014				
Securities available-for-sale				
U.S. government agencies	\$ -	\$ 6,873,553	\$ -	\$ 6,873,553
Mortgage-backed securities	-	15,349,683	-	15,349,683
Collateralized mortgage obligations	-	7,380,799	-	7,380,799
Municipal securities	-	3,444,142	-	3,444,142
SBA-related securities	-	6,397,529	-	6,397,529
2013				
Securities available-for-sale				
U.S. government agencies	\$ -	\$ 6,618,500	\$ -	\$ 6,618,500
Mortgage-backed securities	-	21,012,957	-	21,012,957
Municipal securities	-	1,992,469	-	1,992,469
SBA-related securities	-	8,304,512	-	8,304,512

There were no significant transfers between levels during 2014.

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

	Level 1	Level 2	Level 3	Total
2014				
Impaired loans	\$ -	\$ -	\$ 583,393	\$ 583,393
2013				
Impaired loans	\$ -	\$ -	\$ 738,398	\$ 738,398

PUGET SOUND BANK
NOTES TO FINANCIAL STATEMENTS

Note 18 - Fair Value of Financial Instruments (continued)

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, 2014, along with the valuation techniques used, are shown in the following table:

	Fair Value at December 31, 2014	Valuation Technique	Unobservable Input	Range (Weighted- Average) ¹
Impaired loans	\$ 583,393	Market comparable	Adjustment to appraisal value	0% - 44% (37.9%)

¹ Discount to appraised value

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

Estimated fair values of the Bank's financial instruments at December 31 were as follows:

2014	Carrying Amount	Fair Value	Fair Value Measurements Using		
			Level 1	Level 2	Level 3
Financial assets					
Cash and due from banks	\$ 18,137,860	\$ 18,137,860	\$ 18,137,860	\$ -	\$ -
Interest-bearing deposits in banks	9,961,006	9,961,006	9,961,006	-	-
Securities available-for-sale	39,445,706	39,445,706	-	39,445,706	-
Federal Home Loan Bank and Pacific Coast Bankers'					
Bank stock	585,700	585,700	-	585,700	-
Loans, net	311,001,867	307,839,801	-	-	307,839,801
Accrued interest receivable	894,339	894,339	-	894,339	-
Financial liabilities					
Deposits	\$ 336,592,542	\$ 336,604,837	\$ 309,740,375	\$ 26,864,462	\$ -
Accrued interest payable	37,531	37,531	-	37,531	-

PUGET SOUND BANK **NOTES TO FINANCIAL STATEMENTS**

Note 18 - Fair Value of Financial Instruments (continued)

2013	Carrying Amount	Fair Value	Fair Value Measurements Using		
			Level 1	Level 2	Level 3
Financial assets					
Cash and due from banks	\$ 16,627,030	\$ 16,627,030	\$ 16,627,030	\$ -	\$ -
Interest-bearing deposits in banks	4,205,567	4,205,567	4,205,567	-	-
Securities available-for-sale	37,928,438	37,928,438	-	37,928,438	-
Federal Home Loan Bank and Pacific Coast Bankers' Bank stock	578,600	578,600	-	578,600	-
Loans, net	271,372,481	267,427,730	-	-	267,427,730
Accrued interest receivable	879,431	879,431	-	879,431	-
Financial liabilities					
Deposits	\$ 280,766,929	\$ 280,828,905	\$ 254,834,914	\$ 25,993,991	\$ -
Accrued interest payable	35,825	35,825	-	35,825	-
Borrowings	12,000,000	11,999,320	-	11,999,320	-

Cash and due from banks and accrued interest - The carrying amount represents fair value.

Interest-bearing deposits in banks - The carrying amounts of interest-bearing deposits maturing within 90 days approximate their fair values. Fair values of interest-bearing deposits maturing after 90 days are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities available-for-sale - Fair values are based on quoted market prices or dealer quotations.

Federal Home Loan Bank stock and Pacific Coast Bankers' Bank stock - The carrying value is par value and there is no readily determinable fair value.

Net loans - Fair values are estimated using current market interest rates to discount future cash flows. Interest rates used to discount the cash flows are based on the U.S. Treasury yields or other market interest rates with appropriate spreads. The spread over the treasury yields or other market rates is used to account for liquidity, credit quality, and higher servicing costs. Prepayment rates are based on expected future prepayment rates or, where appropriate and available, market prepayment rates.

Deposit accounts - The fair value of deposits with no stated maturity, such as demand, checking, money market, and savings accounts, equals the amount payable on demand. The fair value of certificates of deposit is calculated based on the discounted value of contractual cash flows. The discount rate is equal to the rate currently offered on similar products.

Borrowings - The fair value of borrowings are estimated using discounted cash flow analyses, based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Off-balance-sheet instruments - The fair value of commitments to extend credit and letters of credit was estimated using the fees currently charged to enter into similar arrangements, 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 they do not have a distinguishable fair value.