



Report of Independent Auditors
and Financial Statements for

Washington Business Bank

December 31, 2016 and 2015

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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REPORT OF INDEPENDENT AUDITORS

Board of Directors
Washington Business Bank

Report on the Financial Statements

We have audited the accompanying financial statements of Washington Business Bank, which comprise the statements of financial condition as of December 31, 2016 and 2015, and the related statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Washington Business Bank as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Everett, Washington
March 3, 2017

WASHINGTON BUSINESS BANK
STATEMENTS OF FINANCIAL CONDITION (dollars in thousands)

ASSETS

	December 31,	
	2016	2015
Cash and due from banks	\$ 2,589	\$ 1,571
Federal funds sold	2,501	2,975
Total cash and cash equivalents	5,090	4,546
Interest-bearing deposits in banks	147	60
Securities available-for-sale, at fair value	195	2,205
Federal Home Loan Bank (FHLB) stock	283	282
Loans receivable	60,144	59,859
Allowance for loan losses	(608)	(645)
Net loans	59,536	59,214
Other real estate owned	197	197
Accrued interest receivable	175	176
Premises and equipment, net	1,879	1,940
Other assets	204	210
Total assets	\$ 67,706	68,830

LIABILITIES AND SHAREHOLDERS' EQUITY

LIABILITIES

Customer deposits	\$ 53,905	\$ 54,919
Accrued interest payable	13	13
FHLB borrowings	5,000	5,000
Other liabilities	219	494
Total liabilities	59,137	60,426

COMMITMENTS AND CONTINGENCIES (NOTE 9)

SHAREHOLDERS' EQUITY

Preferred stock (no par value), 1,000,000 shares authorized, no shares issued or outstanding in 2016 and 2015	-	-
Common stock (\$1 par value), 10,000,000 shares authorized, 710,824 and 750,771 shares issued and outstanding in 2016 and 2015, respectively	711	751
Additional paid-in capital	7,623	7,903
Retained earnings (accumulated deficit)	232	(221)
Accumulated other comprehensive income (loss)	3	(29)
Total shareholders' equity	8,569	8,404
Total liabilities and shareholders' equity	\$ 67,706	\$ 68,830

WASHINGTON BUSINESS BANK
STATEMENTS OF INCOME (dollars in thousands)

	Years Ended December 31,	
	2016	2015
INTEREST INCOME		
Loans and fees	\$ 3,209	\$ 3,462
Federal funds sold and interest-bearing deposits in banks	32	6
Securities available-for-sale	19	51
Total interest income	<u>3,260</u>	<u>3,519</u>
INTEREST EXPENSE		
Deposits	286	272
FHLB borrowings	65	56
Total interest expense	<u>351</u>	<u>328</u>
Net interest income	2,909	3,191
PROVISION FOR LOAN LOSSES	<u>-</u>	<u>-</u>
Net interest income after provision for loan losses	<u>2,909</u>	<u>3,191</u>
NONINTEREST INCOME		
Service charges on deposit accounts	91	82
Other fee income	26	27
Total noninterest income	<u>117</u>	<u>109</u>
NONINTEREST EXPENSE		
Salaries and employee benefits	1,408	1,470
Other real estate owned expenses, net	8	25
Occupancy	153	149
Data processing	129	131
Furniture and equipment	58	57
Other	584	673
Total noninterest expense	<u>2,340</u>	<u>2,505</u>
Income before provision for income taxes	686	795
PROVISION FOR INCOME TAXES	<u>233</u>	<u>270</u>
NET INCOME	<u>\$ 453</u>	<u>\$ 525</u>

WASHINGTON BUSINESS BANK
STATEMENTS OF COMPREHENSIVE INCOME (dollars in thousands)

	Years Ended December 31,	
	<u>2016</u>	<u>2015</u>
NET INCOME	\$ 453	\$ 525
Other comprehensive income		
Unrealized holding gain on securities available-for-sale (net of tax of \$17 and \$6 for 2016 and 2015, respectively)	<u>32</u>	<u>12</u>
COMPREHENSIVE INCOME	<u>\$ 485</u>	<u>\$ 537</u>

WASHINGTON BUSINESS BANK
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (dollars in thousands)

	Common Stock		Additional Paid-In-Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Shares	Amount				
BALANCE, December 31, 2014	803,176	\$ 803	\$ 8,236	\$ (746)	\$ (41)	\$ 8,252
Net income	-	-	-	525	-	525
Unrealized gain on securities, net of tax	-	-	-	-	12	12
Vested restricted stock	6,400	6	(6)	-	-	-
Repurchased shares	(58,805)	(58)	(433)	-	-	(491)
Stock-based compensation	-	-	106	-	-	106
BALANCE, December 31, 2015	750,771	751	7,903	(221)	(29)	8,404
Net income	-	-	-	453	-	453
Unrealized gain on securities, net of tax	-	-	-	-	32	32
Vested restricted stock	6,320	6	(6)	-	-	-
Repurchased shares	(46,267)	(46)	(371)	-	-	(417)
Stock-based compensation	-	-	97	-	-	97
BALANCE, December 31, 2016	<u>710,824</u>	<u>\$ 711</u>	<u>\$ 7,623</u>	<u>\$ 232</u>	<u>\$ 3</u>	<u>\$ 8,569</u>

WASHINGTON BUSINESS BANK
STATEMENTS OF CASH FLOWS (dollars in thousands)

	Years Ended December 31,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 453	\$ 525
Adjustments to reconcile net income to net cash from operating activities		
Deferred income tax	8	48
Depreciation and amortization	70	70
Stock compensation expense	97	106
Changes in operating assets and liabilities		
Accrued interest receivable	1	(13)
Accrued interest payable	-	2
Other assets	(19)	585
Other liabilities	(275)	195
	<u>335</u>	<u>1,518</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale		
Maturities, prepayments, and calls	2,059	68
(Increase) decrease in interest-bearing deposits with banks	(87)	2
Decrease in certificates of deposit	-	277
Increase in loans made to customers, net of principal collections	(322)	(2,579)
Proceeds from sale of other real estate owned	-	237
(Purchase) redemption of FHLB stock	(1)	17
Purchases of premises and equipment	(9)	(84)
	<u>1,640</u>	<u>(2,062)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net decrease in deposits	(1,014)	(114)
Repayment of FHLB borrowings	(2,000)	(1,000)
Advances of FHLB borrowings	2,000	1,000
Repurchase of stock	(417)	(491)
	<u>(1,431)</u>	<u>(605)</u>
NET INCREASE (DECREASE) IN CASH	544	(1,149)
CASH AND CASH EQUIVALENTS, beginning of year	<u>4,546</u>	<u>5,695</u>
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 5,090</u>	<u>\$ 4,546</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for		
Taxes	\$ 485	\$ (169)
Interest	\$ 351	\$ 326
SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING AND FINANCING ACTIVITIES		
Loans transferred to other real estate owned	\$ -	\$ (237)
Change in fair value of securities available-for-sale	\$ 49	\$ 18

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies

Nature of operations - Washington Business Bank (the Bank) operates one full-service branch in Thurston County, Washington. The Bank is a state-chartered bank that provides loan and deposit services to customers who are predominately small and midsized businesses and middle-income individuals in western Washington. The Bank is subject to significant competition from other financial institutions. The Bank is also subject to the regulations of certain federal and state of Washington agencies and undergoes periodic examinations by those regulatory authorities.

Financial statement presentation and use of estimates - The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry. Preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, as of the date of the statements of financial condition, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of impaired loans and other real estate owned, fair value of stock options and awards, and valuation of deferred tax assets.

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

Subsequent events - Subsequent events are events or transactions that occur after the statements of financial condition date but before the 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 statements of financial condition, 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 statements of financial condition but arose after the statements of financial condition date and before the financial statements are available to be issued.

The Bank has evaluated subsequent events through March 3, 2017, which is the date the financial statements are issued.

Cash and cash equivalents - For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks, and federal funds sold, all with maturities of three months or less. The Bank, at times, may have cash deposits at other financial institutions in excess of Federal Deposit Insurance Corporation (FDIC)-insured limits.

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

Note 1 - Summary of Significant Accounting Policies (continued)

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

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated.³¹ Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

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

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

Federal Home Loan Bank stock - The Bank, as a member of the Federal Home Loan Bank of Des Moines (FHLB) system, is required to maintain an investment in capital stock of the FHLB in an amount equal to the greater of 1% of its outstanding home loans or 5% of advances from the FHLB. The Bank's investment in FHLB stock is a restricted investment carried at par value (\$100 per share), which approximates its fair value. No ready market exists for the FHLB stock, and it has no quoted market value; however, 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 made at the discretion of the FHLB.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies (continued)

Management periodically evaluates FHLB stock for impairment. Management's determination of whether its investment is impaired is based on 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 with 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 the legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB; and (4) the liquidity position of the FHLB. Management concluded that its FHLB stock investment was not impaired at December 31, 2016 and 2015.

Pacific Coast Bankers' Bank stock - Pacific Coast Bankers' Bank (PCBB) stock represents an investment by the Bank in the capital stock of PCBB of \$60 at December 31, 2016 and 2015, and is carried at par value (\$15 per share), which reasonably approximates fair value and is included in other assets.

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, 2016 or 2015.

Loan sales recognition - The Bank recognizes a sale on loans if the transferred portion (or portions) and any portion that continues to be held by the transferor are participating interests. 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.

Loans receivable - Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balances and adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method. Because some loans may not be repaid in full, an allowance for loan losses is recorded.

Interest income recognition on loans - Interest income on loans is accrued over the term of the loans based on the principal outstanding. The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, as well as when required by regulatory provision. Past-due status is based on contractual terms of loans. When interest accrual is discontinued, all unpaid accrued interest is reversed. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Note 1 - Summary of Significant Accounting Policies (continued)

Allowance for loan losses - An allowance for loan losses is a valuation allowance for probable incurred credit losses. The allowance for loan losses is increased by a provision for loan losses charged to expense and decreased by charge-offs (net of recoveries). The allowance is based on ongoing, monthly assessments of the probable and estimable losses inherent in the loan portfolio. The Bank's methodology for assessing the appropriateness of the allowance consists of several key elements.

The allowance for loan losses is based upon management's periodic review of the collectibility of the loan in relation to 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 because it requires estimates that are susceptible to significant revision as updated information becomes available. Additionally, loans are subject to examination by state and federal regulators who, based upon their judgment, may require the Bank to make additional provisions or adjustments to the allowance for loan losses.

Specific reserves are established in cases where management has identified significant conditions or circumstances related to a loan that management believes indicate the probability that a loss has been incurred. Impaired loans consist of loans receivable that are not expected to be repaid in accordance with their contractual terms. Smaller balance loans are excluded from this analysis. In addition to impaired loans, any loans risk rated as substandard, doubtful, or loss are individually evaluated for impairment. All other loans are generally evaluated collectively for purposes of estimating the allowance for loan losses.

To determine the balance of the allowance account, loans are pooled by portfolio segment and losses are modeled using historical experience and qualitative and other mathematical techniques over the loss emergence period. The following portfolio segments are used: commercial loans, real estate loans, construction loans, and consumer loans.

Each loan segment inherently contains differing credit risk profiles depending on the unique aspects of that segment. For example, real estate construction loans carry a risk that a project under development might not be completed as planned or that the original cost estimate might be insufficient. In all cases, management believes the credit risk for all loans is similarly dependent on essentially the same factors, including the financial strength of the borrower, the cash flow available to service maturing debt obligations, the condition and value of underlying collateral, the financial strength of any guarantors, and other factors. Management exercises judgment in determining the estimation method that fits the credit risk characteristics of each portfolio segment but generally relies on underlying collateral values, projected cash flows, and other available borrower information.

The establishment of the allowance for loan losses relies on a consistent process that requires multiple layers of management review and judgment and responds to changes in economic conditions, customer behavior, and collateral value, among other influences. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts or to release balances from the allowance for loan losses.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies (continued)

Management monitors differences between estimated and actual incurred loan losses. This monitoring process includes periodic assessments by senior management of loan portfolios and the models used to estimate incurred losses in those portfolios. Additions to the allowance for loan losses are made by charges to the provision for loan losses. Credit exposures deemed to be uncollectible are charged against the allowance for loan losses. Recoveries of previously charged-off amounts are credited to the allowance for loan losses.

The ultimate recovery of all loans is susceptible to future market factors beyond the Bank's control. These factors may result in losses or recoveries differing significantly from those provided in the financial statements.

Impaired, nonaccrual, and charged-off loans - Loans are considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller balance loans of similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected to come from the collateral. Interest payments on impaired loans are typically applied to principal unless collectibility of the principal amount is reasonably assured, in which case interest is recognized on a cash basis.

Impaired loans, or portions thereof, are charged off when deemed uncollectible. The Bank's charge-off policies are treated similarly in each segment of the loan portfolio. When a loan reaches 90 days past due, it is generally considered impaired. The loan is placed on nonaccrual and a specific reserve is allocated after an impairment analysis is performed by management.

The Bank generally places loans on nonaccrual status when the full and timely collection of interest and principal becomes uncertain, part of the principal balance has been charged off and no restructuring has occurred, or the loans reach three months past due for all loan classes. When the Bank places a loan on nonaccrual status, the Bank reverses the accrued unpaid interest receivable against interest income and accounts for the loan on the cash or cost recovery method until it qualifies for return to accrual status. Generally, the Bank returns a loan to accrual status when (a) all delinquent interest and principal become current under the terms of the loan agreement or (b) a formal restructuring has occurred, and continued payment is reasonably assured, generally after six months of payment history.

The Bank has determined that the entire balance of a loan is contractually delinquent for all classes if the minimum payment is not received by the specified due date on the customer's statement. Interest and fees continue to accrue on past-due loans until the date the loan goes into nonaccrual status, if applicable.

Note 1 - Summary of Significant Accounting Policies (continued)

Premises and equipment - Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets. Gains or losses on dispositions are reflected in earnings. Assets are reviewed for impairment when events indicate that their carrying value may not be recoverable. If management determines impairment exists, the assets are reduced with an offsetting charge to expense.

Other real estate owned - Real estate properties acquired through or in lieu of loan foreclosure are initially recorded at fair value less estimated selling cost at the date of foreclosure. Any write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held-for-sale is carried at the lower of the new cost basis or fair value less costs to sell. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

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

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

Deferred taxes result from temporary differences in the recognition of certain income and expense amounts between the Bank's financial statements and its tax return. The principal items giving rise to these differences include net operating losses, valuation adjustments on foreclosed properties, and allowance for credit losses. The Bank's policy is to recognize interest and penalties associated with income tax matters in income tax expense.

Stock-based compensation - 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. The fair value of stock options is determined using the Black-Scholes valuation model.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 1 - Summary of Significant Accounting Policies (continued)

Fair value measurements - Fair values of financial instruments are estimated using relevant market information and other assumptions (Note 14). 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.

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

Comprehensive income - Accounting principles generally require including recognized revenue, expenses, gains, and losses in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the statement of financial condition. Such items, along with net income, are components of comprehensive income. For the years ended December 31, 2016 and 2015, there were no amounts reclassified out of accumulated comprehensive income, and ending components of accumulated comprehensive income consisted of changes to the unrealized gains and losses of securities available-for-sale.

Advertising costs - Advertising costs are expensed as incurred. Total advertising expense was \$22 and \$16 for the years ended December 31, 2016 and 2015, respectively.

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

Note 2 - Restricted Assets

Federal Reserve Board (FRB) regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB. These requirements are generally based on size and other factors. There was no such reserve requirement for the years ended December 31, 2016 and 2015.

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 3 - Securities Available-for-Sale

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

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
December 31, 2016				
Agency mortgage-backed securities and collateralized mortgage obligations	\$ 190	\$ 5	\$ -	\$ 195
Total investment securities	<u>\$ 190</u>	<u>\$ 5</u>	<u>\$ -</u>	<u>\$ 195</u>
December 31, 2015				
U.S. government and agency securities	\$ 1,998	\$ -	\$ (51)	\$ 1,947
Agency mortgage-backed securities and collateralized mortgage obligations	<u>251</u>	<u>7</u>	<u>-</u>	<u>258</u>
Total investment securities	<u>\$ 2,249</u>	<u>\$ 7</u>	<u>\$ (51)</u>	<u>\$ 2,205</u>

There were no securities with unrealized losses at December 31, 2016, and one security with unrealized losses at December 31, 2015.

	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Totals</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
December 31, 2016						
Agency mortgage-backed securities and collateralized mortgage obligations	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
December 31, 2015						
U.S. government and agency securities	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,947</u>	<u>\$ (51)</u>	<u>\$ 1,947</u>	<u>\$ (51)</u>

There were no contractual maturities of investments at December 31, 2016. Expected maturities of agency mortgage-backed securities and collateralized mortgage obligations may differ from contractual maturities because borrowers may have the right to call or prepay the obligations and they are, therefore, classified separately with no specific maturity date. Amortized cost and fair value of agency mortgage-backed securities and collateralized mortgage obligations totaled \$190 and \$195, respectively at December 31, 2016.

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

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans Receivable

Loans consisted of the following at December 31:

	<u>2016</u>	<u>2015</u>
Commercial	\$ 22,749	\$ 25,029
Real estate		
Commercial	25,186	25,026
Multi-family	3,241	3,040
Residential - 1-4 family	<u>6,007</u>	<u>2,635</u>
Total real estate	34,434	30,701
Construction	3,102	4,292
Consumer	<u>33</u>	<u>29</u>
	60,318	60,051
Less net deferred loan origination fees	<u>174</u>	<u>192</u>
Loans receivable	<u><u>\$ 60,144</u></u>	<u><u>\$ 59,859</u></u>

The Bank pledged certain commercial, multi-family, 1-4 family residential, and land loans as collateral for purposes of borrowings with the FHLB and FRB. Loans totaling \$7,369 and \$8,018 were pledged to the FHLB at December 31, 2016 and 2015, respectively. There were \$5,391 and \$7,929 in loans pledged to the FRB at December 31, 2016 and 2015, respectively (Note 7).

Reflected in the allowance for loan loss methods previously described is an amount for imprecision or uncertainty that incorporates the range of probable outcomes inherent in estimates used for the allowance, which may change from period to period. This amount is the result of management's judgment of risks inherent in the portfolios, economic uncertainties, historical loss experience, and other subjective factors, including industry trends, calculated to better reflect the Bank's view of risk in each loan portfolio. No single statistic or measurement determines the adequacy of the allowance for loan loss. Changes in the allowance for loan loss and the related provision expense can materially affect net income.

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans Receivable (continued)

The following tables present, by portfolio segment, the changes in the allowance for loan losses for the years ended December 31 and the amount of loans evaluated for impairment individually and collectively.

2016	<u>Commercial</u>	<u>Real Estate</u>	<u>Construction</u>	<u>Consumer</u>	<u>Total</u>
Allowance					
Balance, beginning of the period	\$ 553	\$ 68	\$ 20	\$ 4	\$ 645
Charge-offs	(45)	-	-	-	(45)
Recoveries	8	-	-	-	8
Provision (recapture)	-	-	-	-	-
Balance, end of the period	<u>\$ 516</u>	<u>\$ 68</u>	<u>\$ 20</u>	<u>\$ 4</u>	<u>\$ 608</u>
Ending balance individually evaluated for impairment	<u>\$ 132</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 132</u>
Ending balance collectively evaluated for impairment	<u>\$ 384</u>	<u>\$ 68</u>	<u>\$ 20</u>	<u>\$ 4</u>	<u>\$ 476</u>
Loans					
Ending balance	<u>\$ 22,749</u>	<u>\$ 34,434</u>	<u>\$ 3,102</u>	<u>\$ 33</u>	<u>\$ 60,318</u>
Ending balance individually evaluated for impairment	<u>\$ 587</u>	<u>\$ 402</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 989</u>
Ending balance collectively evaluated for impairment	<u>\$ 22,162</u>	<u>\$ 34,032</u>	<u>\$ 3,102</u>	<u>\$ 33</u>	<u>\$ 59,329</u>
2015					
Allowance					
Balance, beginning of the period	\$ 558	\$ 205	\$ 20	\$ 4	\$ 787
Charge-offs	(44)	(144)	-	-	(188)
Recoveries	39	7	-	-	46
Provision (recapture)	-	-	-	-	-
Balance, end of the period	<u>\$ 553</u>	<u>\$ 68</u>	<u>\$ 20</u>	<u>\$ 4</u>	<u>\$ 645</u>
Ending balance individually evaluated for impairment	<u>\$ 20</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 20</u>
Ending balance collectively evaluated for impairment	<u>\$ 533</u>	<u>\$ 68</u>	<u>\$ 20</u>	<u>\$ 4</u>	<u>\$ 625</u>
Loans					
Ending balance	<u>\$ 25,029</u>	<u>\$ 30,701</u>	<u>\$ 4,292</u>	<u>\$ 29</u>	<u>\$ 60,051</u>
Ending balance individually evaluated for impairment	<u>\$ 45</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 45</u>
Ending balance collectively evaluated for impairment	<u>\$ 24,984</u>	<u>\$ 30,701</u>	<u>\$ 4,292</u>	<u>\$ 29</u>	<u>\$ 60,006</u>

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans Receivable (continued)

Credit quality information - The following table represents credit exposures by risk category for the years ended December 31. The use of various categories to grade loans permits management's use of migration analysis to estimate a portion of credit risk.

	Exceptional	Quality	Average	Below Average	Watch List	Substandard	Total
2016							
Commercial	\$ 946	\$ 600	\$ 15,971	\$ 4,637	\$ 440	\$ 155	\$ 22,749
Real estate							
Commercial	-	5,539	17,299	1,654	292	402	25,186
Multi-family	-	-	2,233	1,008	-	-	3,241
Residential 1-4 family	-	19	4,489	1,499	-	-	6,007
Total real estate	-	5,558	24,021	4,161	292	402	34,434
Construction	-	-	2,631	471	-	-	3,102
Consumer	-	-	-	33	-	-	33
	<u>\$ 946</u>	<u>\$ 6,158</u>	<u>\$ 42,623</u>	<u>\$ 9,302</u>	<u>\$ 732</u>	<u>\$ 557</u>	<u>\$ 60,318</u>
2015							
Commercial	\$ 1,037	\$ 1,130	\$ 17,392	\$ 5,416	\$ -	\$ 54	\$ 25,029
Real estate							
Commercial	-	4,499	17,675	2,282	400	170	25,026
Multi-family	-	-	1,999	1,041	-	-	3,040
Residential 1-4 family	-	54	2,247	334	-	-	2,635
Total real estate	-	4,553	21,921	3,657	400	170	30,701
Construction	-	-	3,805	106	-	381	4,292
Consumer	-	-	29	-	-	-	29
	<u>\$ 1,037</u>	<u>\$ 5,683</u>	<u>\$ 43,147</u>	<u>\$ 9,179</u>	<u>\$ 400</u>	<u>\$ 605</u>	<u>\$ 60,051</u>

The Bank's internal risk grading system is based on experiences with similarly graded loans. Category ratings are reviewed periodically at the segment level, at which time management analyzes the resulting scores, as well as other external statistics and factors, to track the migration of loan performance. Credit quality details are generally updated annually using information obtained from the Bank's internal loan review processes, from regulatory examinations, and from external loan review consultants. Loans that trend upward toward higher levels generally have a lower loss factor associated with that category, whereas loans that migrate toward lower ratings generally will result in a higher loss factor being applied to those related loan balances. There were no loans classified as doubtful or loss at December 31, 2016 or 2015.

The Bank's internal risk categories are based on a variety of detailed factors obtained during loan underwriting and subsequent loan review procedures. A summary of these risk categories is described as follows:

Exceptional loans - Excellent and well documented primary and secondary sources of repayment. Excellent capital levels and management with significant industry experience and succession plans. More than adequately secured loans with no loss exposure.

Note 4 - Loans Receivable (continued)

Quality loans - Strong sources of primary and secondary repayment; loans comply in all respects to Bank policy and applicable regulations. Better than average capital levels with proven, experienced management. Acceptable collateral with above average loan-to-value ratios resulting in no loss exposure.

Average loans - Adequate sources of repayment as evidenced by an average level of earnings, debt service coverage, and capital levels compared with industry peer groups. Experienced management in most critical roles of the organization. Acceptable collateral in quality and amount that results in no loss exposure.

Below average loans - Below average sources of repayment, with marginal identifiable risk of collection. Modest secondary source of repayment provides limited support. Below average capital levels compared with peer group, and management may be untested or lack depth. Below average collateral position that may have limited liquidation value. Minimal loss exposure expected based on consideration of all relevant factors.

Watch list loans - These loans are typically of higher quality than substandard or doubtful loans but have been determined to have identified potential weaknesses in debt service coverage, collateral value, or other factors and are rated watch list in order to receive special attention and review by the Bank's credit department. These loans are consistently reviewed and regraded monthly. This grade is intended to correspond with a "Pass" rating used by regulators.

Substandard loans - These loans are inadequately protected by the paying capacity of the borrower, current sound net worth, or pledged collateral. A substandard loan typically has one or more well defined weaknesses that could jeopardize the repayment of the debt.

Doubtful loans - Loans with weaknesses inherent in the substandard classification for which collection and liquidation in full is questionable.

Loss - This rating is assigned to loans considered uncollectible and of such little value that their continuance as an active bank-owned asset is not warranted. These loans are immediately charged off.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans Receivable (continued)

Past-due loans receivable by class - The following table includes an aging analysis of the outstanding principal balance of past-due loans receivable as of December 31, 2016 and 2015. No loans were delinquent greater than 90 days and still accruing interest as of December 31, 2016 or 2015.

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Nonaccrual Loans
2016							
Commercial	\$ 595	\$ -	\$ -	\$ 595	\$ 22,154	\$ 22,749	\$ 587
Real estate							
Commercial	-	292	402	694	24,492	25,186	402
Multi-family	-	-	-	-	3,241	3,241	-
Residential 1-4 family	-	-	-	-	6,007	6,007	-
Total real estate	-	292	402	694	33,740	34,434	402
Construction	-	-	-	-	3,102	3,102	-
Consumer	-	-	-	-	33	33	-
	<u>\$ 595</u>	<u>\$ 292</u>	<u>\$ 402</u>	<u>\$ 1,289</u>	<u>\$ 59,029</u>	<u>\$ 60,318</u>	<u>\$ 989</u>
2015							
Commercial	\$ 9	\$ -	\$ 45	\$ 54	\$ 24,975	\$ 25,029	\$ 45
Real estate							
Commercial	-	170	-	170	24,856	25,026	-
Multi-family	-	-	-	-	3,040	3,040	-
Residential 1-4 family	-	-	-	-	2,635	2,635	-
Total real estate	-	170	-	170	30,531	30,701	-
Construction	-	381	-	381	3,911	4,292	-
Consumer	-	-	-	-	29	29	-
	<u>\$ 9</u>	<u>\$ 551</u>	<u>\$ 45</u>	<u>\$ 605</u>	<u>\$ 59,446</u>	<u>\$ 60,051</u>	<u>\$ 45</u>

Impaired loans - The following table includes the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable. The average balances are calculated based on the quarter-end balances of the loans of the period reported.

	Recorded Investment	Unpaid Principal Balance	Associated Allowance	Average Recorded Investment	Interest Income Recognized
2016					
With no specific allowance	<u>\$ 402</u>	<u>\$ 402</u>	<u>\$ -</u>	<u>\$ 402</u>	<u>\$ 11</u>
With an allowance					
Commercial	<u>\$ 587</u>	<u>\$ 587</u>	<u>\$ 131</u>	<u>\$ 587</u>	<u>\$ 4</u>
2015					
With no specific allowance	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
With an allowance					
Commercial	<u>\$ 45</u>	<u>\$ 45</u>	<u>\$ 20</u>	<u>\$ 45</u>	<u>\$ -</u>

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 4 - Loans Receivable (continued)

Modifications - A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Bank offers and participates in various types of concessions when modifying a loan. There were no troubled debt restructurings at December 31, 2016 or 2015. No loans were modified in 2016 or 2015 as TDRs.

Related party loans - Certain related parties of the Bank, principally Bank directors and their associates, are loan customers of the Bank in the ordinary course of business.

	2016	2015
Outstanding at beginning of year	\$ 1,801	\$ 1,206
Key officers and directors	-	-
New loan advances	68	2,332
Loan repayments	(212)	(669)
Transfers out	-	(1,068)
Outstanding at end of year	\$ 1,657	\$ 1,801

Note 5 - Premises and Equipment

Components of premises and equipment at December 31 are as follows:

	2016	2015
Land	\$ 437	\$ 437
Building	1,956	1,954
Furniture and fixtures	167	167
Equipment	530	522
Software	58	58
	3,148	3,138
Less accumulated depreciation and amortization	1,269	1,198
	\$ 1,879	\$ 1,940

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 5 - Premises and Equipment (continued)

During 2014, the Bank purchased a building in Olympia, Washington, moving the Bank's headquarters and branch location. The lease contract for previous branch premises expires in December 2018 and contains an escalation clause based on increases in property taxes and other costs. Rental expense of leased premises was \$127 for both 2016 and 2015. The minimum annual lease payments through the initial lease term for the year ending December 31 are as follows:

2017	\$ 127
2018	<u>127</u>
	<u>\$ 254</u>

A portion of the previous branch premises was subleased to a third party in 2014. Sublease income was \$34 for 2016 and 2015, included within occupancy expenses on the statements of income. Minimum rental receipts under the sublease agreement for future years ending December 31 are as follows:

2017	\$ 35
2018	<u>35</u>
	<u>\$ 70</u>

Note 6 - Customer Deposits

The composition of deposits at December 31 is as follows:

	<u>2016</u>	<u>2015</u>
Demand deposits, noninterest-bearing	\$ 9,403	\$ 9,021
NOW and money market accounts	14,240	12,518
Savings deposits	2,709	6,129
Time certificates	<u>27,553</u>	<u>27,251</u>
	<u>\$ 53,905</u>	<u>\$ 54,919</u>

The aggregate amount of time certificates of \$250,000 and over was approximately \$914 and \$908 as of December 31, 2016 and 2015, respectively.

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 6 - Customer Deposits (continued)

Scheduled maturities of time certificates are as follows:

2017	\$ 18,762
2018	4,912
2019	1,873
2020	1,238
2021	<u>768</u>
	<u>\$ 27,553</u>

Included within NOW and money market accounts were brokered deposits of \$0 and \$4,021 as of December 31, 2016 and 2015, respectively.

Deposits from certain related parties of the Bank, principally directors, officers, and their affiliates, at December 31, 2016 and 2015, amounted to approximately \$3,520 and \$2,690, respectively.

Note 7 - FHLB Borrowings and Credit Arrangements

The Bank has a committed line of credit through the FRB of San Francisco for a discounted rate based on the type of loans pledged as collateral (Note 4). Loans pledged to the FRB equated to a borrowing capacity of \$5,391 and \$7,929 at December 31, 2016 and 2015. There were no outstanding balances under this credit arrangement at December 31, 2016 and 2015.

The Bank also has a line-of-credit agreement with an unaffiliated bank totaling \$3,500. This line provides for lending at the bank's federal fund rates. There were no borrowings outstanding on this line at December 31, 2016 and 2015.

The Bank is a member of the FHLB, which entitles it to certain benefits including a variety of borrowing options. Credit capacity is determined by the FHLB based on a number of factors, including amount of eligible collateral. The Bank's borrowing capacity at December 31, 2016, was approximately \$2,369. The FHLB borrowing facilities are additionally collateralized by a blanket pledge of the Bank's assets.

At December 31, 2016, the Bank had \$5,000 of fixed-rate borrowings outstanding with the FHLB, with fixed rates ranging from 1.39% to 1.57% under these agreements. The contractual maturities of FHLB advances at December 31, 2016, are as follows:

2017	\$ 2,000
2018	<u>3,000</u>
	<u>\$ 5,000</u>

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 7 - FHLB Borrowings and Credit Arrangements (continued)

The maximum and average outstanding balances and average interest rates on advances from the FHLB were as follows:

	<u>2016</u>	<u>2015</u>
Average balance during the year	\$ 5,000	\$ 5,000
Average interest rate during the year	1.48%	1.15%
Maximum month-end balance during the year	5,000	5,000
Weighted-average rate at year-end	1.47%	1.29%

Note 8 - Income Taxes

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

	<u>2016</u>	<u>2015</u>
Current	\$ 225	\$ 222
Deferred	8	48
	<u>\$ 233</u>	<u>\$ 270</u>

The Bank's effective tax rate varies from the statutory rate of 34% primarily due to the effects of nondeductible meals and other permanent differences.

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

	<u>2016</u>	<u>2015</u>
Deferred tax assets		
Stock-based compensation expense	\$ 61	\$ 59
Allowance for loan losses	69	69
Accumulated depreciation	4	(24)
Write-downs on other real estate owned	16	16
Total deferred tax assets	<u>150</u>	<u>120</u>
Deferred tax liabilities		
Cash basis reporting	38	15
Unrealized loss on securities	2	(15)
Deferred income	88	73
Total deferred tax liabilities	<u>128</u>	<u>73</u>
Net deferred tax assets	<u>\$ 22</u>	<u>\$ 47</u>

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 8 - Income Taxes (continued)

The Bank's income tax filings are subject to audit by various taxing authorities. The Bank's policy is to recognize income tax-related interest and penalties in income tax expense. The Bank incurred no interest and penalties for the years ended December 31, 2016 and 2015.

Note 9 - Commitments and Contingencies

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

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 and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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

	<u>2016</u>	<u>2015</u>
Commitments to extend credit	<u>\$ 6,527</u>	<u>\$ 5,942</u>
Standby letters of credit	<u>\$ 218</u>	<u>\$ 130</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Because many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are issued primarily to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies, as specified above, and is required in instances where the Bank deems it necessary.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 9 - Commitments and Contingencies (continued)

Because of the nature of its activities, the Bank may be subject to legal actions that arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the financial position of the Bank.

The Bank has entered into agreements with executive officers that provide for payouts contingent upon a change in control.

Note 10 - Significant Concentrations of Credit Risk

Credit risk represents the possibility of sustaining a loss because the other parties to the financial obligation fail to perform in accordance with the terms of the contract. The Bank's exposure to credit loss primarily relates to cash and due from banks, FHLB stock, loans receivable, and investment securities.

Most of the Bank's business activity is with customers in the state of Washington. Investments in state and municipal securities involve governmental entities primarily within the state. Loans are generally limited by state banking regulations to 20% of the Bank's shareholders' equity, excluding accumulated other comprehensive income. At December 31, 2016 and 2015, \$3,102 and \$4,292, respectively, of loans receivable were made for land development, acquisition, and construction purposes.

Note 11 - Retirement Plan

The Bank has established a 401(k) plan to which employees can elect to defer a portion of their pay, up to up to a maximum allowed by the IRS. At management's discretion, the Bank can make a matching contribution. For the years ended December 31, 2016 and 2015, the Bank contributed \$35 and \$27, respectively.

Note 12 - Stock Incentive Plans

During 2009, the shareholders approved the Bank's 2009 Stock Incentive Plan. Awards up to 150,000 shares under the plan may be granted to any director, officer, employee, or other person providing services to the Bank. Awards may consist of stock options, grants of restricted shares of common stock, or grants of restricted share units. During April 2014, the shareholders approved the Bank's 2014 Stock Incentive Plan. Awards up to 150,000 shares under the plan may be granted to any director, officer, employee, or other person providing services to the Bank. Awards may consist of stock options, grants of restricted shares of common stock, or grants of restricted share units. There were 102,450 shares remaining in the Plans at December 31, 2016, available to grant for options or restricted stock. The maximum term of these awards is 10 years.

The exercise price of each option equals the fair market value of the Bank's stock on the date of grant. An award of restricted shares is an outright grant of shares that are subject to vesting requirements, which, if not satisfied, result in the forfeiture of the shares.

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 12 - Stock Incentive Plans (continued)

Restricted shares are deemed issued and outstanding for all purposes, including voting rights and dividends, but are subject to restrictions on sale or transfer. Restricted share units are rights to acquire shares upon satisfaction of vesting requirements, with the underlying shares not issued or outstanding until such vesting requirements are satisfied.

Stock options - The fair value of each option grant is estimated on the date of grant, based on the Black-Scholes option pricing model.

A summary of the status of the Bank's stock options as of December 31, 2016, and changes during the year ended is presented below:

	<u>Shares</u>	<u>Weighted-Average Exercise Price</u>	<u>Weighted-Average Contractual Life (Years)</u>
Outstanding at beginning of year	187,450	\$ 8.17	5.70
Forfeited	<u>(9,050)</u>	<u>8.22</u>	<u> </u>
Outstanding at end of year	<u>178,400</u>	<u>\$ 8.17</u>	<u>4.55</u>
Exercisable at end of year	<u>143,010</u>	<u>\$ 8.06</u>	<u>4.17</u>

There were no options granted or exercised in 2016 or 2015.

Restricted share units - A summary of the status of the Bank's restricted stock units as of December 31, 2016, and changes during the year ended is presented below:

	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value per Share</u>
Outstanding at beginning of year	20,570	\$ 8.39
Granted	4,900	12.34
Vested	(6,320)	8.85
Forfeited	<u>-</u>	<u>-</u>
Outstanding at end of year	<u>19,150</u>	<u>\$ 9.25</u>

The total fair value of shares vested during the years ended December 31, 2016 and 2015, was \$56 and \$50, respectively. Restricted share units are valued using the fair value as determined by a valuation specialist.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 12 - Stock Incentive Plans (continued)

Compensation expense recorded in the financial statements for stock-based plans for the years ended December 31, 2016 and 2015, totaled \$97 and \$106, respectively. Unrecognized compensation expense totaled \$210 as of December 31, 2016, of which \$180 and \$30 are attributed to restricted share units and options, respectively. The weighted-average period over which this remaining compensation cost will be recognized is 2.05 years.

Note 13 - Regulatory Matters

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2016, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, common equity tier 1, and Tier 1 leverage ratios, as set forth in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

WASHINGTON BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS

Note 13 - Regulatory Matters (continued)

The Bank's actual capital amounts and ratios are also presented in the following table. Management believes, as of December 31, 2016, that the Bank meets all capital requirements to which it is subject.

December 31, 2016	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital (to risk-weighted assets)	\$ 9,181	16.37%	\$ 4,487	8.00%	\$ 5,609	10.00%
Tier I capital (to risk-weighted assets)	8,564	15.27%	3,366	6.00%	4,487	8.00%
Common equity Tier 1 capital (to risk-weighted assets)	8,564	15.27%	2,524	4.50%	3,646	6.50%
Tier I capital (to adjusted average assets)	8,564	12.63%	2,713	4.00%	3,391	5.00%
December 31, 2015						
Total risk-based capital (to risk-weighted assets)	\$ 9,086	16.24%	\$ 4,476	8.00%	\$ 5,596	10.00%
Tier I capital (to risk-weighted assets)	8,432	15.07%	3,357	6.00%	4,476	8.00%
Common equity Tier 1 capital (to risk-weighted assets)	8,432	15.07%	2,518	4.50%	3,637	6.50%
Tier I capital (to adjusted average assets)	8,432	12.37%	2,726	4.00%	3,408	5.00%

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Bank on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2016 is 0.625%. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital. Management believes as of December 31, 2016, that the Bank meets all capital adequacy requirements to which it is subject.

Note 14 - Fair Value Measurements

Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements*, establishes a three-level valuation hierarchy for disclosure of fair value measurements and enhances disclosure requirements for fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

WASHINGTON BUSINESS BANK

NOTES TO FINANCIAL STATEMENTS

Note 14 - Fair Value Measurements (continued)

The three levels are defined as follows:

Level 1 - Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 - Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 - Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Following is a description of the valuation methodologies used to measure and report fair value of financial and nonfinancial assets and liabilities, as well as the general classification of such instruments pursuant to the valuation hierarchy:

Securities available-for-sale - The Bank reports securities available-for-sale at fair value on a recurring basis. The fair value of the Bank's securities available-for-sale are determined using Level 2 inputs, which are derived from quoted prices for identical or similar assets in markets that are active or not active, i.e., markets in which there are a few transactions for the asset, the prices are not current, or price quotations vary substantially either over time or among market makers, or in which little information is released publicly.

Impaired loans - Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on customized discounting criteria.

Other real estate owned - Other real estate owned consists principally of properties acquired through foreclosure and is carried at the lower of cost or estimated market value less selling costs. Any write-downs based on the asset's fair value at the date of acquisition is charged to the allowance for loan losses. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell.

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Note 14 - Fair Value Measurements (continued)

Assets reported at fair value on a recurring basis - The following table presents the balances of assets reported at fair value measured on a recurring basis at December 31:

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
2016				
Agency mortgage-backed securities and collateralized mortgage obligations	<u>\$ 195</u>	<u>\$ -</u>	<u>\$ 195</u>	<u>\$ -</u>
2015				
U.S. government and agency securities	\$ 1,947	\$ -	\$ 1,947	\$ -
Agency mortgage-backed securities and collateralized mortgage obligations	<u>258</u>	<u>-</u>	<u>258</u>	<u>-</u>
	<u>\$ 2,205</u>	<u>\$ -</u>	<u>\$ 2,205</u>	<u>\$ -</u>

Assets reported at fair value on a nonrecurring basis - The following table represents the balances of assets reported at fair value measured on a nonrecurring basis at December 31, excluding any assets whose fair value exceeds historical cost:

	<u>Fair Value Measurements Using</u>		
	<u>Quoted Prices in Active Markets for Identical Assets Level 1</u>	<u>Significant Other Observable Inputs Level 2</u>	<u>Significant Unobservable Inputs Level 3</u>
December 31, 2016			
Impaired loans	\$ -	\$ -	\$ 858
Other real estate owned	-	-	197
December 31, 2015			
Impaired loans	\$ -	\$ -	\$ 25
Other real estate owned	-	-	197

Quantitative information about Level 3 fair value measurements - The range and weighted average of the significant unobservable inputs used to fair value Level 3 nonrecurring assets during the years ending December 31, 2016 and 2015, along with the valuation techniques used, are shown in the following table:

	<u>Fair Value at December 31, 2016</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range (Weighted Average)¹</u>
Impaired loans	\$ 858	Market comparable	Adjustment to appraisal value	0-35% (14%)
Other real estate owned	197	Market comparable	Adjustment to appraisal value	7% - 10% (7.8%)

¹ Discount to appraised value.

	<u>Fair Value at December 31, 2015</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range (Weighted Average)¹</u>
Impaired loans	\$ 25	Market comparable	Adjustment to appraisal value	10% (10%)
Other real estate owned	197	Market comparable	Adjustment to appraisal value	7% - 10% (7.8%)

¹ Discount to appraised value.