# Fresno First Bank

# 2012

## Annual Report

## Message from the Chairman

When Fresno First Bank opened in December 2005 the Board of Director's goal was to focus on serving the business needs in the greater Fresno area. We wanted to create an unparalleled model of client services with a foundational culture of shared employee ownership.

In 2013, we believe our vision has taken root, thanks in great part to the associates at the Bank who have embraced the direction set by the Board and continue to guide it every day. In the last several years, our culture has also continued to evolve, with commitment to our clients and creating value for our shareholders, remaining at the forefront of everything we do.

Since opening the Bank, we have faced many challenges, especially with the decline in the economy, which has had a direct impact on the banking industry, as well as our community as a whole. However, we have continued to support Fresno-area business throughout the economic downturn and are confident that, as we move forward, we will see the results of our culture at work at Fresno First Bank, in the increase in shareholder value.

The Board, Management, and Associates at Fresno First Bank stand firm in our vision and have resolved to deliver long-term value to our shareholders; and we would like to express our appreciation to our shareholders for their continued support.

David N. Price
Chairman of the Board

FRESNO FIRST BANK


## Mission Statement

The mission of Fresno First Bank is to become the Bank of choice for business owners, professionals, entrepreneurs and individuals that value a high touch approach, or "relationship" approach to their banking needs. We will accomplish this by:

- Developing an ownership culture that fosters a working environment which encourages professional and financial growth and entrepreneurial freedom.
- Committing to exceed customer service expectations for quality, responsiveness and professional excellence.
- Generating a superior return for our shareholders while investing in the communities we serve.

## Values Statement

Fresno First Bank will be the Bank of choice for successful businesses and individuals who value superior service and a relationship approach to their banking and financing needs. Our group of experienced professional bankers will help clients navigate through complex financial choices which will ultimately assist in stimulating economic growth in our community. Our commitment to an ownership culture will foster an exceptional work environment that generates a fair return for our shareholders.

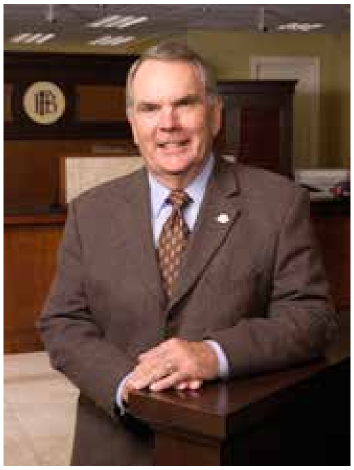
## Core Values

***We Value:***

- The highest standard of ethical behavior and professional integrity.
- An owner-orientated working environment dedicated to teamwork that encourages respect and dignity, while recognizing and rewarding innovation and exceptional performance.
- Proactive, solutions-orientated recommendations that consistently exceed client expectations.
- The loyalty of our client relationships gained by knowing, understanding and placing their needs first.

FRESNO FIRST BANK

## Message from the President & CEO



I am pleased to report that Fresno First Bank has finished its fourth consecutive year with an impressive financial score card.

Fresno First Bank reported net income for the year of $1,171,000. Total assets increased to $210.3 million up $32.6 million or 18.3%, and total deposits reached $186.4 million for an increase of 17.4%. Although after tax earnings were down $745,000 from 2011, it was the result of 2012's tax expense of $812,000 coupled with a tax benefit of $344,000 in 2011. On a pre-tax comparison of 2012 vs. 2011 we made $1,983,000 in 2012 vs. $1,572,000 in 2011, a 26.1% increase year over year. In addition, we were successful in completing our Preferred Stock offering, raising $6.1 million, enabling us to pay back TRAP funds, pay our shareholders a 5% stock dividend and build our capital reserves to continue our growth strategy.

Through the efforts of our staff and the Board, we were successful in continuing both our asset and earnings growth. In the second half of the year, we saw a significant increase in deposit clients and balances. Loan growth was impressive and the additions to our loan staff, including an experienced Agricultural lender, will support expanded loan volume in 2013. With the continued pressure on our net interest margin, we have made major investments to diversify and improve other income streams. The areas of focus have been our SBA department, Residential Mortgage Services and our Merchant Services department. I am pleased to report that our investments are paying off.

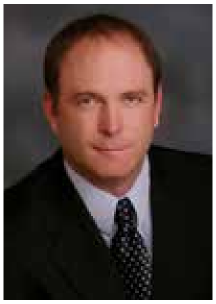
Non-interest income for the year increased to $1,299,000 vs. $788,000 for 2011 representing a 64.8% increase. During the year we saw impressive growth in both the Mortgage Originations and Merchant Services department. In addition, we expanded our SBA staff to support additional growth in the government guaranteed loan area and support our efforts to continue to grow other non-interest income.

Looking forward, we are well positioned to continue our growth. We have the capital, the team and culture to successfully execute our strategic plan, improving earnings and shareholder return.

Richard "Rick" Whitsell
President & CEO

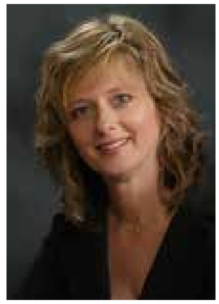
FRESNO FIRST BANK

## Board of Directors

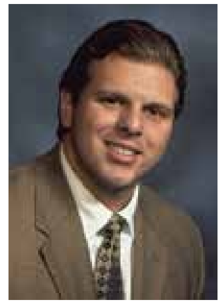


*Jack Holt,*
**Director / President of Holt Lumber Company, Inc.**

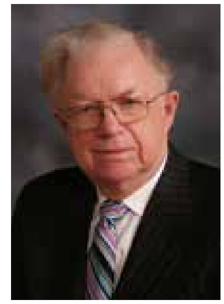
*Dr. Robert Kubo,*
**Director/Orthodontist, Kubo Orthodontic Group**



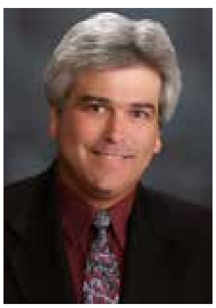
*Lorrie Lorenz,*
**Director / Principal of Lorenz & Associates**



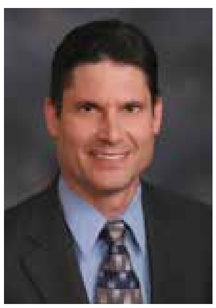
*Jared Martin,*
**Director / Realtor, Keller Williams Realty**



*David Price,*
**Chairman of the Board / President and CEO of David N. Price & Associates**



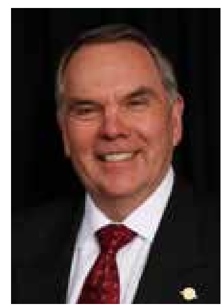
*Mark Saleh,*
**Director / President of Wm. B. Saleh & Company**



*Joel Slonski,*
**Director / CPA with Slonski & Sailors**

*Al Smith,*
**Director / President and CEO of the Greater Fresno Area Chamber of Commerce**

*Dr. Daniel Suchy,*
**Director / Retired Physician**



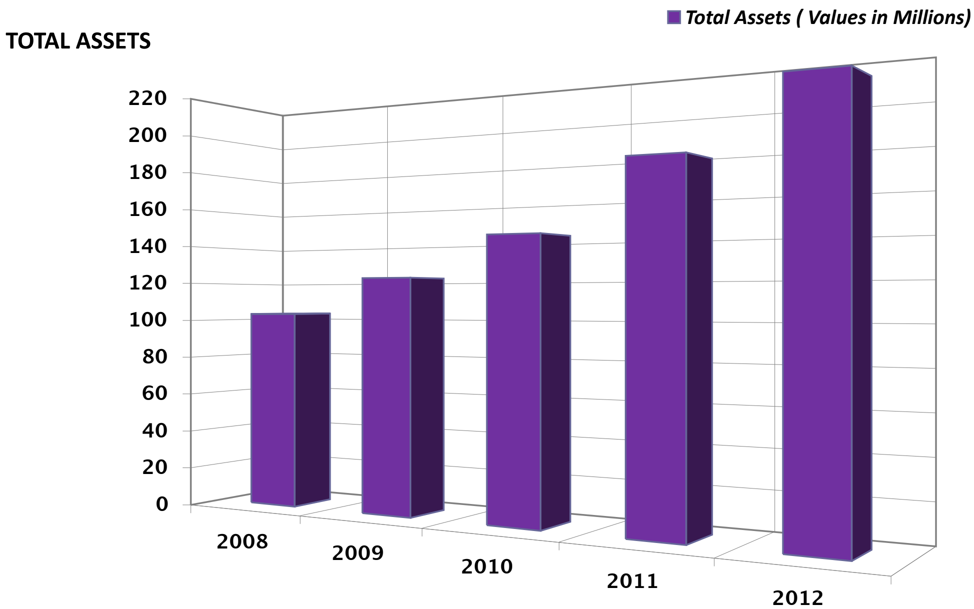
*Richard Whitsell,*
**Director / President and CEO of Fresno First Bank**

Since the founding of our Bank in 2005, our dedicated Board of Directors has provided leadership and an unwavering commitment to the strength of the Bank and the communities we serve.

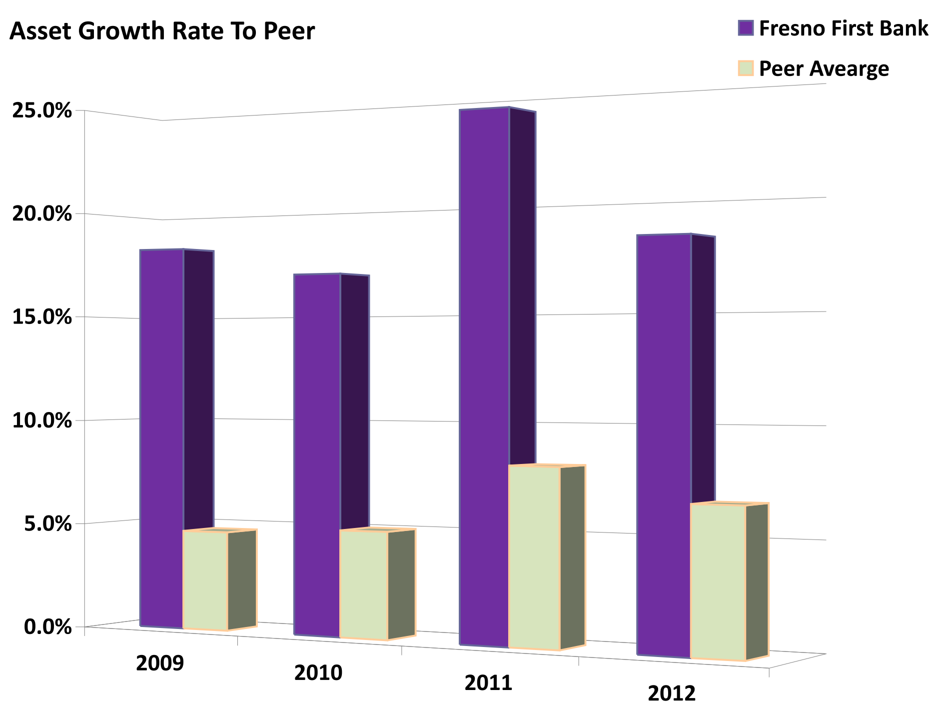
At Fresno First Bank we believe that corporate governance begins with a well educated and informed Board, Management and Staff. Our Directors participate in a rigorous education program and actively participate in conferences conducted by the Western Independent Bankers, the National Association of Corporate Directors, the California Bankers Association and various regulatory compliance courses throughout the year. The Bank's Chairman, David Price is also a member of the WIB Advisory Committee for the Annual Bank Chairman's Forum and a regular participant in the Annual Corporate Governance Conference.

Our Board of Directors and the employees of Fresno First Bank also actively support a number of non-profit organizations throughout the year. Some of which include the American Heart Association, American Red Cross, Community Food Bank, Habitat for Humanity, United Cerebral Palsy, Valley Crime Stoppers, Exceptional Parents Unlimited, Salvation Army and many other local non-profit organizations.

*Over the last four years total assets have more than doubled from $103 million to more than $210 million at December 31, 2012. As our assets grow so does our ability to generate additional interest income which will increase earnings and shareholder value.*

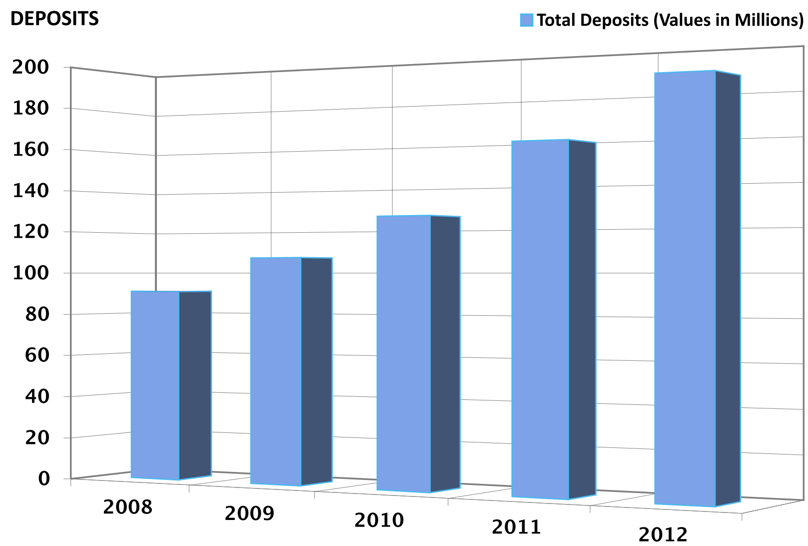


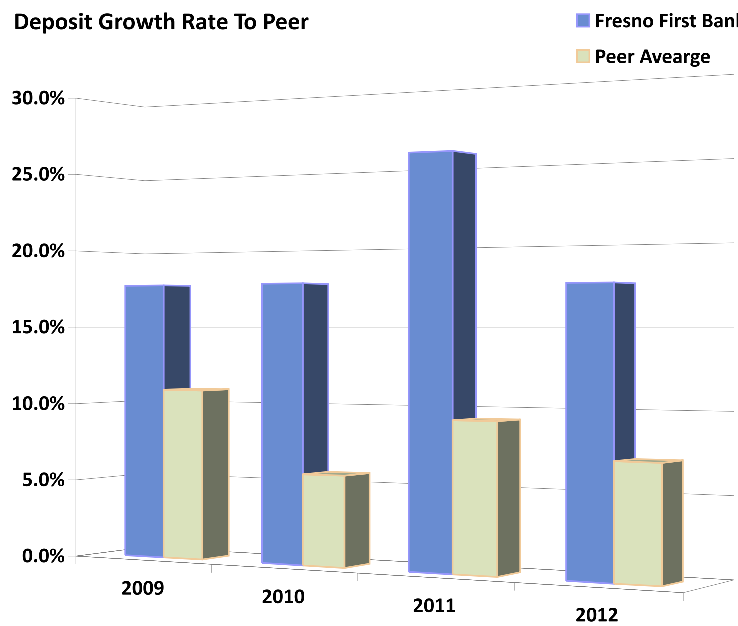

*To benchmark our growth compared to similar banks, we use data gathered from regulatory reports filed with the FDIC and provided by SNL Financial. Peer information below consists of data from 30 banks geographically located in markets similar to Fresno First's. These banks range geographically from Bakersfield to Sacramento and from the Central Coast to the Sierra Nevada Mountains. The banks range in size from $91 million to $983 million in total assets with a median size of $185 million. In comparison to the peer group, Fresno First Bank's growth rate has consistently exceeded the average of our peers. Our ability to grow during troubled economic times is a testament to our associates and their ability to offer quality relationship banking that has been well received within our market.*

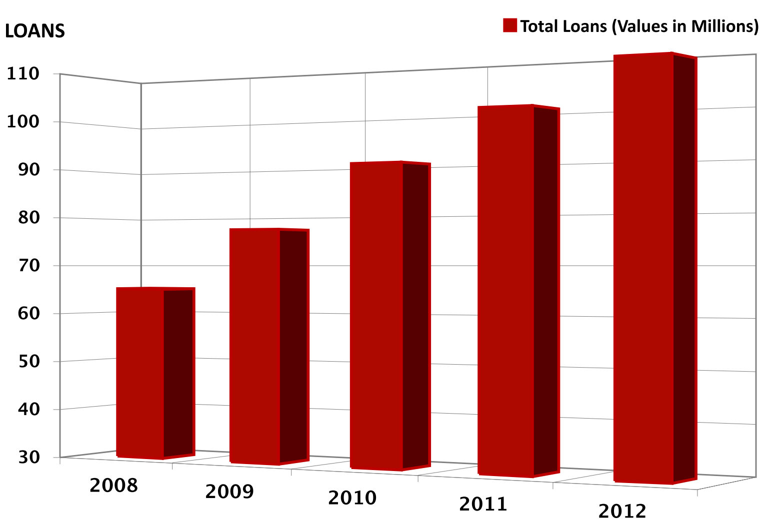


Deposit growth is the catalyst for our growth in assets. Obtaining low cost local core deposits one relationship at a time is what we do every day. Over the last four years our deposits have increased 105%, from $91 million to more than $186 million at December 31, 2012.*

*With more than 34% of our deposits held in zero interest checking accounts, our overall cost of funds is a relatively low .28%. This has allowed our Bank to maintain a superior net interest margin compared to peers. Over the past four years, we have been able to grow our deposit base at nearly twice the average of peer banks.*

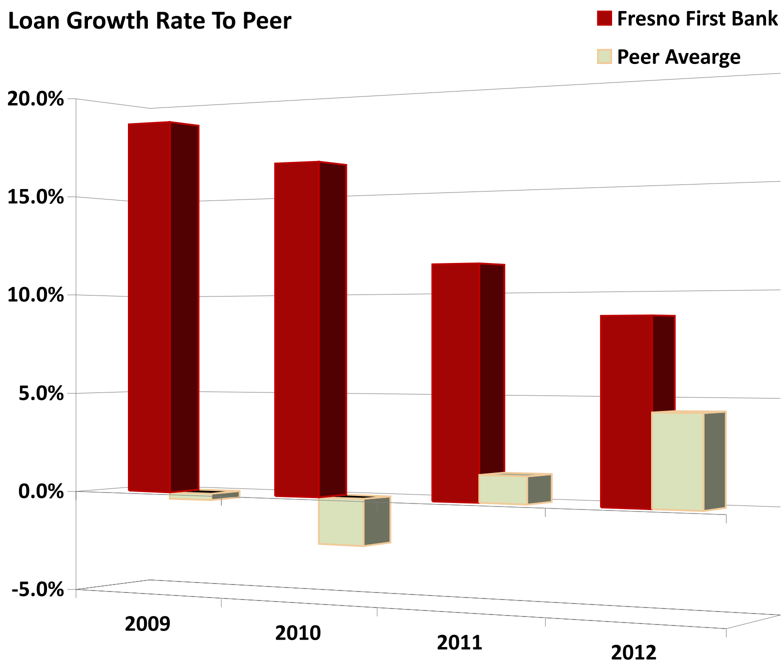



*During a time when other banks have ceased to lend and in some cases shrunk their loan portfolios, our loan portfolio has grown from $65 million at December 31, 2008 to $109 million today. Our portfolio is well diversified and our credit quality ratios rank Fresno First Bank above peer banks. We pride ourselves in taking a consultative approach with our borrowing customers, tailoring*

FRESNO FIRST BANK

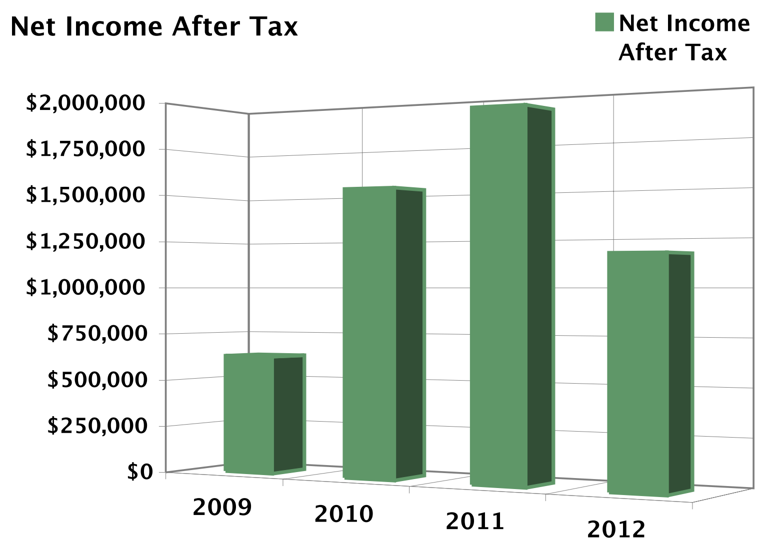


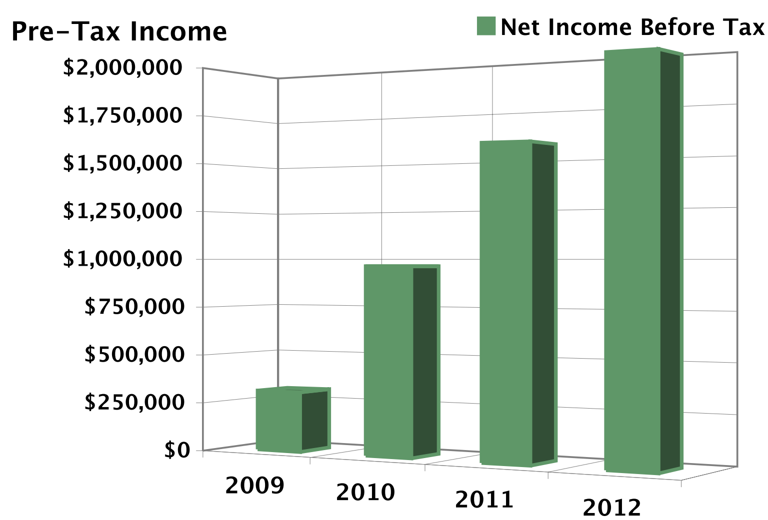

*lending solutions to meet client credit needs which will allow their business to flourish.*

*In comparison to peer banks our growth has far exceeded the average. While our percentage loan growth year-over-year has declined as our loan portfolio has grown in dollars outstanding, our growth has continued to exceed our peer banks.*

*In 2009 we reached profitability and have now recorded four consecutive profitable years. In 2012 net income after tax was down from 2011 as a result of a tax expense of $812,000 compared to a tax benefit of $344,000 in 2011. The chart below displays a more apples-to-apples comparison (income before tax expense or tax benefit) of the trend of income growth the bank has experienced over the last four years.*

*In addition to our superior net interest margin we have focused on diversifying the Bank's non-interest income through new initiatives. Over the last three years we have started a government guaranteed lending department, a mortgage department and a merchant services department within the Bank. All three initiatives are profitable and adding to the Bank's bottom line.*

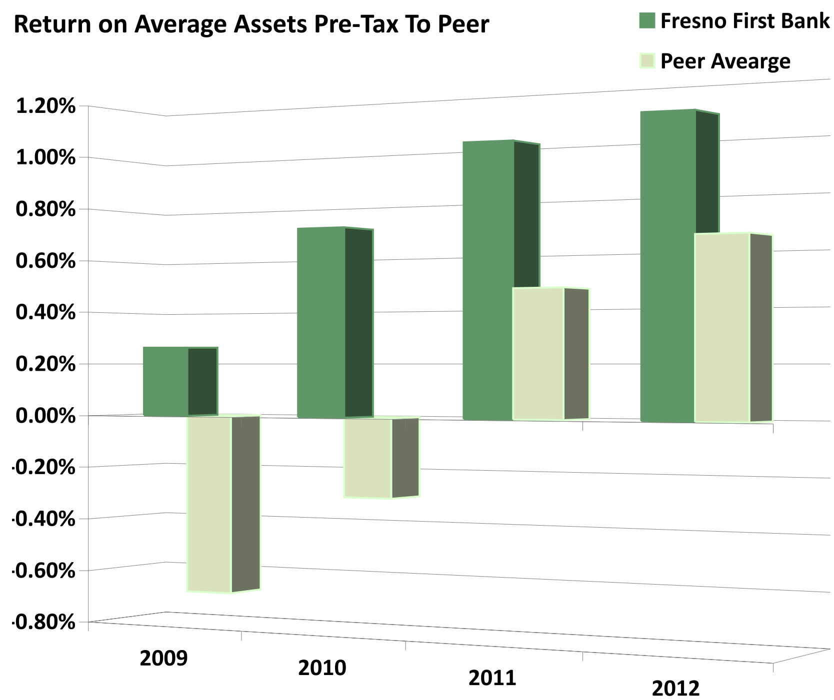


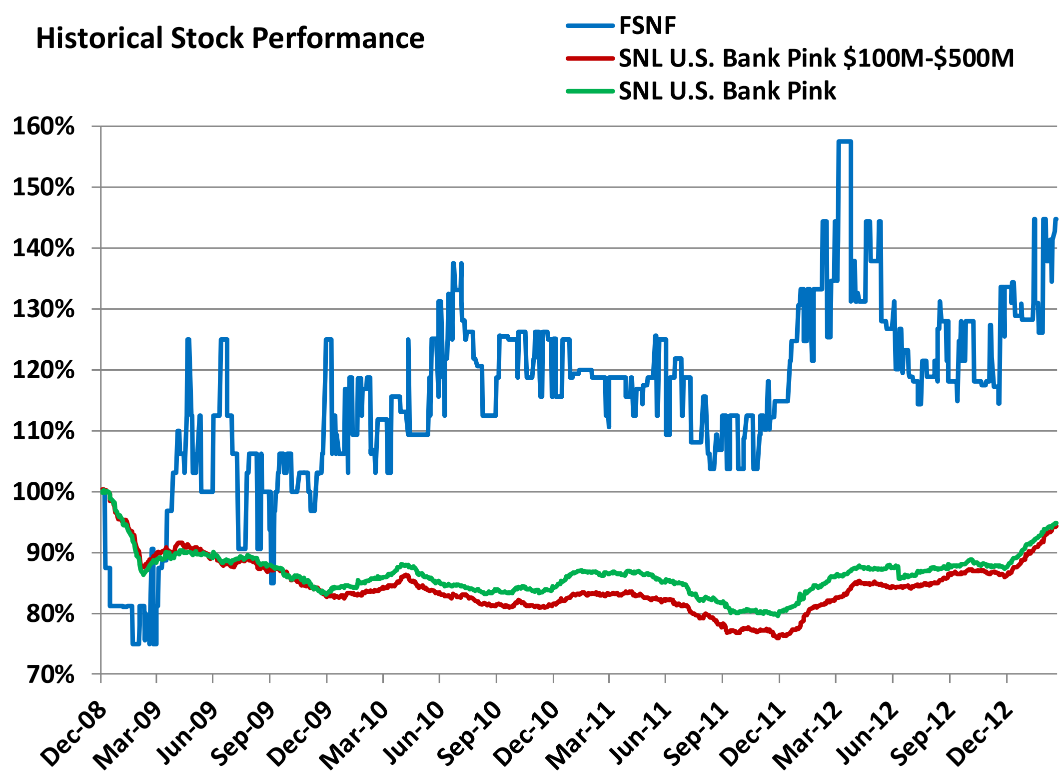
Fresno First Bank

*In the years to come, our goal is to continue to expand these business lines while implementing new and innovative services to enhance the overall profitability of the Bank.*

*To the right we compare our return on average assets to the peer bank group. Fresno First Bank's performance compared to industry peers is very positive but Management, the Board and our Associates are seeking ever higher financial performance.*




*In 2007/2008 the broad stock market declines hit the financial services industry hard. While Fresno First Bank's stock has posted more than a 40% gain over the last five years larger bank indices have yet to fully recover. The chart below illustrates the relative performance of Fresno First Bank's stock vs. a broad index of banks of similar size and market.*



Report of Independent Auditors
and Financial Statements

# Fresno First Bank

December 31, 2012 and 2011

MOSS-ADAMS LLP

Certified Public Accountants | Business Consultants

*Acumen. Agility. Answers.*

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MOSS ADAMS LLP
Certified Public Accountants | Business Consultants

# REPORT OF INDEPENDENT AUDITORS

To the Board of Directors and Shareholders
**Fresno First Bank**

## Report on Financial Statements

We have audited the accompanying financial statements of Fresno First Bank, which comprise the balance sheets as of December 31, 2012 and 2011, and the related statements of operations, 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 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 Fresno First Bank as of December 31, 2012 and 2011, 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

Stockton, California
March 15, 2013

**FRESNO FIRST BANK**

## ASSETS

| | DECEMBER 31, 2012 | DECEMBER 31, 2011 |
|---|---|---|
| Cash and due from banks | $ 11,033,163 | $ 10,591,802 |
| Federal funds sold | 18,575,000 | 6,070,000 |
| Interest bearing deposits in banks | 3,250,000 | 3,001,970 |
| Total cash and cash equivalents | 32,858,163 | 19,663,772 |
| Certificates of deposit | 747,000 | - |
| Securities available-for-sale | 63,921,698 | 56,409,131 |
| Loans, net | 106,464,501 | 97,348,521 |
| Federal Home Loan Bank stock, at cost | 941,600 | 781,300 |
| Premises and equipment | 471,806 | 600,437 |
| Other real estate owned | 2,223,493 | - |
| Interest receivable and other assets | 2,653,934 | 2,892,931 |
| | $ 210,282,195 | $ 177,696,092 |

## LIABILITIES AND SHAREHOLDERS' EQUITY

| | 2012 | 2011 |
|---|---|---|
| Deposits | $ 186,447,327 | $ 158,774,338 |
| Interest payable and other liabilities | 567,095 | 701,084 |
| Total liabilities | 187,014,422 | 159,475,422 |
| Commitments and contingencies (Notes 4 and 11) | | |
| Shareholders' equity: | | |
| Preferred stock – 5,000,000 shares authorized, $1,000 par value Series A shares and Series B shares, 2,066 issued and outstanding in 2011 | - | 2,063,278 |
| $100 par value Series C shares 61,000 issued and outstanding in 2012 | 5,715,038 | - |
| Common stock – 5,000,000 shares authorized, no par value; 1,857,893 and 1,766,010 shares issued and outstanding in 2012 and 2011, respectively | 18,384,665 | 17,599,944 |
| Additional paid-in capital | 1,626,381 | 1,563,586 |
| Accumulated deficit | (3,092,670) | (3,405,470) |
| Accumulated other comprehensive income, net | 634,359 | 399,332 |
| Total shareholders' equity | 23,267,773 | 18,220,670 |
| Total liabilities and shareholders' equity | $ 210,282,195 | $ 177,696,092 |

| | YEARS ENDED DECEMBER 31, 2012 | 2011 |
|---|---|---|
| INTEREST INCOME | | |
| Interest and fees on loans | $ 6,550,149 | $ 6,260,604 |
| Interest on investment securities | 1,136,171 | 1,093,999 |
| Interest on federal funds sold and other | 47,987 | 30,303 |
| Total interest income | 7,734,307 | 7,384,906 |
| INTEREST EXPENSE | | |
| Interest on savings deposits, NOW, and money market accounts | 221,879 | 220,955 |
| Interest on time deposits | 347,834 | 497,229 |
| Interest on other borrowings | 11 | 4 |
| Total interest expense | 569,724 | 718,188 |
| Net interest income | 7,164,583 | 6,666,718 |
| PROVISION FOR LOAN LOSSES | 783,000 | 500,000 |
| Net interest income after provision for loan losses | 6,381,583 | 6,166,718 |
| NON-INTEREST INCOME | | |
| Service charges on deposits | 452,056 | 319,556 |
| Mortgage fee income | 297,302 | 389,321 |
| Gain on sale of investment securities | 100,615 | - |
| Gain on sale of loans held-for-sale | 324,114 | - |
| Gain on sale of other real estate owned | 67,476 | - |
| Other operating income | 57,753 | 79,602 |
| Total non-interest income | 1,299,316 | 788,479 |
| NON-INTEREST EXPENSES | | |
| Salaries and employee benefits | 3,261,374 | 2,937,830 |
| Occupancy and equipment expenses | 555,995 | 556,974 |
| Regulatory assessments | 139,497 | 279,926 |
| Data processing fees | 381,240 | 347,921 |
| Professional fees | 189,755 | 247,366 |
| Marketing and business promotion | 272,453 | 251,470 |
| Director fees and stock-based compensation | 211,799 | 194,987 |
| Other expenses | 686,098 | 566,551 |
| | 5,698,211 | 5,383,025 |
| Income before income taxes | 1,982,688 | 1,572,172 |
| Provision (benefit) for income taxes | 812,000 | (344,000) |
| Net income | $ 1,170,688 | $ 1,916,172 |
| Preferred stock dividends and accretion | $ 105,772 | $ 139,887 |
| Net income available to common shareholders | $ 1,064,916 | $ 1,776,285 |
| Net income per share – basic | $ 0.60 | $ 0.95 |
| Net income per share – diluted | $ 0.44 | $ 0.95 |

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| Net income | $ 1,170,688 | $ 1,916,172 |
| Available-for-sale securities: | | |
| Unrealized holding gains (losses) during the year | 498,986 | (111,762) |
| Reclassification adjustment for gains realized in net income | (100,615) | - |
| Net unrealized gains (losses) | 398,371 | (111,762) |
| Income tax expense | (163,344) | (9,380) |
| Other comprehensive income (loss) | 235,027 | (121,142) |
| Total comprehensive income | $ 1,405,715 | $ 1,795,030 |

*See accompanying notes*

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

| | Preferred Stock | | Common Stock | | Additional | Accumulated | Accumulated Other Comprehensive | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Paid-in Capital | Deficit | Income | Total |
| Balances, December 31, 2010 | 2,066 | $ 2,030,611 | 1,678,663 | $ 16,861,096 | $ 1,486,202 | $ (4,475,311) | $ 520,474 | $ 16,423,072 |
| Stock-based compensation | - | - | - | - | 77,384 | - | - | 77,384 |
| Exercise of stock options | - | - | 3,333 | 33,130 | - | - | - | 33,130 |
| Dividend paid on preferred stock | - | - | - | - | - | (107,220) | - | (107,220) |
| Accretion of preferred stock | - | 32,667 | - | - | - | (32,667) | - | - |
| Five percent stock dividend | - | - | 84,014 | 705,718 | - | (705,718) | - | - |
| Cash paid in lieu of fractional shares | - | - | - | - | - | (726) | - | (726) |
| Net income | - | - | - | - | - | 1,916,172 | - | 1,916,172 |
| Other comprehensive loss | - | - | - | - | - | - | (121,142) | (121,142) |
| Balances, December 31, 2011 | 2,066 | 2,063,278 | 1,766,010 | 17,599,944 | 1,563,586 | (3,405,470) | 399,332 | 18,220,670 |
| Stock-based compensation | - | - | - | - | 62,795 | - | - | 62,795 |
| Exercise of stock options | - | - | 3,674 | 34,944 | - | - | - | 34,944 |
| Dividend paid on Series A and B preferred stocks | - | - | - | - | - | (103,050) | - | (103,050) |
| Accretion of Series A and B preferred stocks | - | 2,722 | - | - | - | (2,722) | - | - |
| Five percent common stock dividend | - | - | 88,209 | 749,777 | - | (749,777) | - | - |
| Cash paid in lieu of fractional shares | - | - | - | - | - | (2,339) | - | (2,339) |
| Issuance of Series C preferred stock, net of stock offering costs of $384,962 | 61,000 | 5,715,038 | - | - | - | - | - | 5,715,038 |
| Redemption of Series A and B preferred stocks | (2,066) | (2,066,000) | - | - | - | - | - | (2,066,000) |
| Net income | - | - | - | - | - | 1,170,688 | - | 1,170,688 |
| Other comprehensive income | - | - | - | - | - | - | 235,027 | 235,027 |
| Balances, December 31, 2012 | 61,000 | $ 5,715,038 | 1,857,893 | $ 18,384,665 | $ 1,626,381 | $ (3,092,670) | $ 634,359 | $ 23,267,773 |

*See accompanying notes*

# STATEMENTS OF CASH FLOWS

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | $ 1,170,688 | $ 1,916,172 |
| Adjustments to reconcile net income to net cash from operating activities: | | |
| Depreciation and amortization of premises and equipment | 203,900 | 182,879 |
| Amortization and accretion of premiums and discounts on securities available-for-sale, net | 391,446 | 253,924 |
| Provision for loan losses | 783,000 | 500,000 |
| Gain on sale of investment securities | (100,615) | - |
| Gain on sale of loans held-for-sale | (324,114) | - |
| Gain on sale of other real estate owned | (67,476) | - |
| Proceeds from sale of loans held-for-sale | 12,555,757 | - |
| Originations of loans held-for-sale | (12,231,643) | - |
| Stock-based compensation | 62,795 | 77,384 |
| Decrease (increase) in deferred taxes | 256,000 | (862,000) |
| (Decrease) increase in interest payable and other liabilities | (133,989) | 122,851 |
| (Increase) decrease in interest receivable and other assets | (180,347) | 150,471 |
| Net cash from operating activities | 2,385,402 | 2,341,681 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Purchase of certificates of deposit | (747,000) | - |
| Purchase of available-for-sale securities | (48,177,128) | (49,061,210) |
| Proceeds from maturities of available-for-sale securities | 39,241,916 | 33,236,512 |
| Proceeds from sale of available-for-sale securities | 1,530,185 | - |
| Net increase in loans | (12,392,460) | (10,260,528) |
| Purchase of Federal Home Loan Bank stock | (160,300) | (145,000) |
| Proceeds from sale of other real estate owned | 337,463 | - |
| Purchases of premises and equipment | (75,269) | (94,694) |
| Net cash from investing activities | (20,442,593) | (26,324,920) |

| | YEARS ENDED DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Net increase in demand deposits and savings accounts | 33,271,619 | 30,091,936 |
| Net (decrease) increase in time deposits | (5,598,630) | 2,575,838 |
| Net proceeds from issuance of Series C preferred stock | 5,715,038 | - |
| Redemption of Series A and B preferred stocks | (2,066,000) | - |
| Cash paid in lieu of fractional shares | (2,339) | (726) |
| Payment of dividends on Series A and B preferred stocks | (103,050) | (107,220) |
| Common stock issued | 34,944 | 33,130 |
| Net cash from financing activities | 31,251,582 | 32,592,958 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 13,194,391 | 8,609,719 |
| CASH AND CASH EQUIVALENTS, beginning of period | 19,663,772 | 11,054,053 |
| CASH AND CASH EQUIVALENTS, end of period | $ 32,858,163 | $ 19,663,772 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Interest paid | $ 573,320 | $ 722,192 |
| Taxes paid | $ 529,000 | $ 552,000 |
| NON-CASH INVESTING ACTIVITIES: | | |
| Transfer of loans to other real estate owned | $ 2,493,480 | $ - |

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of Fresno First Bank (the Bank) conform to generally accepted accounting principles and general practices within the banking industry. A summary of the significant accounting policies applied in the preparation of the accompanying financial statements follows.

**Nature of operations –** The Bank is incorporated in the state of California and organized as a single operating segment that operates one full-service office in Fresno, California. The Bank's primary source of revenue is providing loans to customers, who are predominately small and middle-market businesses and individuals.

**Estimates –** In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reported period. Actual results could differ from those estimates.

The allowance for loan losses is the most significant accounting estimate reflected in the Bank's financial statements. The allowance for loan losses includes charges to reduce the recorded balances of loans receivable to their estimated net realizable value, as appropriate. The allowance is based on estimates, and ultimate losses may vary from current estimates. These estimates for losses are based on individual assets and their related cash flow forecasts, sales values, independent appraisals, the volatility of certain real estate markets, and concern for disposing of real estate in distressed markets. Although management of the Bank believes the estimates underlying the calculation of specific allowances are reasonable, there can be no assurances that the Bank could ultimately realize these values. In addition to providing valuation allowances on specific assets where a decline in value has been estimated, the Bank establishes general valuation allowances for losses based on the overall portfolio composition, general market conditions, concentrations, and prior loss experience.

Other significant management judgments and accounting estimates reflected in the Bank's financial statements include:

- Decisions regarding the timing and placement of loans on non-accrual;
- Determination, recognition, and measurement of impaired loans;
- Recognition and measurement of asset servicing rights;
- Determination and evaluation of deferred tax assets and liabilities;
- Determination of the fair value of other real estate owned;
- Determination of the fair value of stock option awards; and
- Determination of the fair value of financial instruments.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Concentrations of credit risk –** Assets and liabilities that subject the Bank to concentrations of credit risk consist of cash balances at other banks, loans, and deposits. Most of the Bank's customers are located within Fresno County and the surrounding areas. The Bank's primary lending products are discussed in Note 3 to the financial statements. The Bank did not have any significant concentrations in its business with any one customer or industry. The Bank obtains what it believes to be sufficient collateral to secure potential losses on loans. The extent and value of collateral varies based on the details underlying each loan agreement.

As of December 31, 2012 and 2011, the Bank has cash deposits at other financial institutions in excess of FDIC insured limits. However, as the Bank places these deposits with major financial institutions and monitors the financial condition of these institutions, management believes the risk of loss to be minimal. Banking regulations require that banks maintain a percentage of their deposits as reserves in cash or on deposit with the Federal Reserve Bank. The Bank complied with the reserve requirements as of December 31, 2012 and 2011.

**Cash and cash equivalents –** For purposes of reporting cash flows, cash equivalents include cash, due from banks, interest-bearing deposits in financial institutions with maturities of 90 days or less, and federal funds sold. Generally, federal funds are sold for one-day periods and interest-bearing deposits are for periods of 90 days or less.

**Securities available-for-sale –** Available-for-sale securities consist of U.S. Treasury securities, U.S. Agency securities, obligations of states and political subdivisions, obligations of U.S. Corporations, mortgage-backed securities, and other securities not classified as trading securities or held-to-maturity securities. These securities are carried at estimated fair value with unrealized holding gains and losses, net of tax, reported as a separate component of accumulated other comprehensive income, until realized. Gains and losses on the sale of available-for-sale securities are determined using the specific identification method. The amortization of premiums and accretion of discounts are recognized as adjustments to interest income using the interest method over the period to call or maturity.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other than temporary. This assessment includes a determination of whether the Bank intends to sell the security, or if it is more likely than not that the Bank will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other than temporarily impaired and that the Bank does not intend to sell and will not be required to sell prior to recovery of the amortized cost basis, the amount of impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors.

The credit loss component is recognized in earnings and is calculated as the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of the future expected cash flows is deemed to be due to factors that are not credit related and is recognized in other comprehensive income.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Loans –** Loans are reported at the principal amount outstanding, net of deferred loan fees and costs and the allowance for loan losses. Unearned discounts on installment loans are recognized as income over the terms of the loans. Interest on other loans is calculated by using the simple interest method on the daily balance of the principal amount outstanding.

Loan fees, net of certain direct costs of origination, are deferred and amortized over the contractual term of the loan as an adjustment to the interest yield. During the years ended December 31, 2012 and 2011, salaries and employee benefits expense totaling $51,954 and $49,536, respectively, were deferred as loan origination costs.

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. Accrual of interest on loans is discontinued either when reasonable doubt exists as to the full and timely collection of interest or principal or when a loan becomes contractually past due by 90 days or more with respect to interest or principal. When a loan is placed on non-accrual status, all interest previously accrued, but not collected, is reversed against current period interest income. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

**Allowance for loan losses –** The allowance for loan losses is established through a provision for loan losses charged to operations. Loan losses are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely. Subsequent recoveries of previously charged off amounts, if any, are credited to the allowance.

Management employs a systematic methodology for determining the allowance for loan losses. On a regular basis, management reviews the credit quality of the loan portfolio and considers problem loans, delinquent loans, existing general economic conditions affecting the key lending areas of the Bank, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, specific industry conditions, recent loss experience, duration of the current business cycle, bank regulatory examination results, and findings of the Bank's internal credit examiners. The allowance for loan losses at December 31, 2012 and 2011 reflects management's estimate of probable losses in the portfolio. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired. Impaired loans, as defined, are measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the collateral if the loan is collateral dependent. The general component relates to non-impaired loans and is based on historical loss experience and loss history experienced by the Bank’s peers when the Bank did not have losses in a particular loan class, adjusted for qualitative factors impacting the loan portfolio. An unallocated component is maintained to cover uncertainties that could affect management’s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Allowance for loan losses (continued) –** The Bank considers a loan impaired when it is probable that all amounts of principal and interest due will not be collected 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, current credit worthiness, and the amount of the shortfall in relation to the principal and interest owed.

**Troubled debt restructuring –** In situations where, for economic or legal reasons related to a borrower's financial difficulties, the Bank grants a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring. The Bank measures any loss on the troubled debt restructuring in accordance with the guidance concerning impaired loans set forth above. Additionally, loans modified in troubled debt restructurings are generally placed on non-accrual status at the time of restructuring. These loans are returned to accrual status after the borrower demonstrates performance with the modified terms for a sustained period of time (generally six months) and has the capacity to continue to perform in accordance with the modified terms of the restructured debt.

**Federal Home Loan Bank (FHLB) stock –** The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. Both cash and stock dividends are reported as income.

**Premises and equipment –** Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives, which range from three to seven years for computer equipment, equipment, and furniture. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the improvements or the remaining lease term, whichever is shorter. Expenditures for betterments or major repairs are capitalized and those for ordinary repairs and maintenance are charged to operations as incurred.

**Advertising costs –** The Bank expenses the costs of advertising in the period incurred. Advertising expense was $170,121 and $121,449 for the years ended December 31, 2012 and 2011, respectively.

**Other real estate owned –** Real estate acquired by foreclosure, or deed in lieu of foreclosure is recorded at fair value at the date of foreclosure, establishing a new cost basis by a charge to the allowance for loan losses, if necessary. Fair value is based on current appraisals less estimated selling costs. Any subsequent write-downs are charged against operating expenses and recognized as a valuation allowance. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other operating expenses. During 2012, the Bank foreclosed on two loans and transferred $2,493,480 to other real estate owned. The Bank sold one property with proceeds of $337,463 and recognized gain on sale of $67,476 in 2012. There were no foreclosures or sales of other real estate owned in 2011.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Income taxes –** The Bank uses the asset and liability method to account for income taxes. Under such method, deferred tax assets and liabilities are recognized for the future tax consequences of differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis (temporary differences). 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 in the period of enactment.

A valuation allowance against net deferred tax assets is established to the extent that it is more likely than not that the benefits associated with the deferred tax assets will not be fully realized.

In accordance with accounting standards, the Bank has assessed its tax positions and has concluded there are no unrecognized tax benefits at December 31, 2012 and 2011.

The Bank recognizes interest accrued and penalties related to unrecognized tax benefits in tax expense. During the years ended December 31, 2012 and 2011, the Bank recognized no interest and penalties.

The Bank files income tax returns in the U.S. federal jurisdiction and with the state of California. The Bank is subject to U.S. federal or state income tax examinations by tax authorities for years beginning 2008.

**Comprehensive income –** Changes in unrealized gains and losses on available-for-sale securities are the only component of accumulated other comprehensive income for the Bank.

**Fair value measurement –** Fair value is 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. Current accounting guidance establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or a liability.

See Note 14 for more information and disclosures relating to the Bank's fair value measurements.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**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 as described in Note 15. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

**Earnings per share (EPS) –** Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. The treasury stock method is applied to determine the dilutive effect of stock options when computing diluted earnings per share.

**Stock-based compensation –** The Bank recognizes the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period that an employee is required to provide services in exchange for the award, generally the vesting period. See Note 12 for additional information on the Bank's stock option plan.

**Transfers of financial assets –** Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Servicing rights –** The Bank sells or transfers loans, including the guaranteed portion of United States Department of Agriculture (USDA) loans (with servicing retained) for cash proceeds equal to the principal amount of loans, as adjusted to yield interest to the investor based upon the current market rates. The Bank records an asset representing the right to service a loan for others when it sells a loan and retains the servicing rights. The carrying value of the loan is allocated between the loan and the servicing rights, based on their relative fair values. The fair value of servicing rights is estimated by discounting estimated future cash flows from servicing using discount rates that approximate current market rates and estimated prepayment rates.

The servicing rights are initially measured at fair value and amortized in proportion to and over the period of the estimated net servicing income assuming prepayments. Additionally, management assesses the servicing rights for impairment as of each financial reporting date. For purposes of evaluating and measuring impairment, servicing rights are based on a discounted cash flow methodology, current prepayment speeds, and market discount rates. Any impairment is measured as the amount by which the carrying value of servicing rights for a stratum exceeds its fair value. The carrying value of servicing rights at December 31, 2012 and 2011 were $44,087 and $50,311, respectively. No impairment charges were recorded for the years ended December 31, 2012 or 2011 related to servicing assets.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

**Reclassifications –** Certain reclassifications have been made to the 2011 financial statements to conform to the classifications used in 2012.

**Adoption of new accounting standards –** In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income* (Topic 220), *Presentation of Comprehensive Income*. The ASU improves the comparability, consistency, and transparency of financial reporting and increases the prominence of items reported in other comprehensive income. The amendments to Topic 220 require entities to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Entities are no longer permitted to present components of other comprehensive income as part of the statement of changes in stockholders' equity. Any adjustments for items that are reclassified from other comprehensive income to net income are to be presented on the face of the entities' financial statement regardless of the method of presentation for comprehensive income. The amendments do not change items to be reported in comprehensive income or when an item of other comprehensive income must be reclassified to net income, nor do the amendments change the option to present the components of other comprehensive income either net of related tax effects or before related tax effects. ASU 2011-05 is effective for fiscal years and interim periods beginning on or after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income* (Topic 220), *Presentation of Comprehensive Income,* to effectively defer only those changes in Update 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments will be temporary to allow the Board time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. The amendments in this ASU are effective at the same time as the amendments in ASU No. 2011-05 so that entities will not be required to comply with the presentation requirements in ASU No. 2011-05 that this ASU is deferring. We have adopted these ASUs in 2012 and provided the applicable disclosure in the Statements of Comprehensive Income.

In February 2013, the FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income.* The ASU requires entities to provide enhanced disclosures to present separately by component, reclassifications out of accumulated other comprehensive income. An entity is required to disclose in the notes to the financial statements or parenthetically on the face of the financial statements, the effect of significant items reclassified out of accumulated other comprehensive income on the respective line items of net income, but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety. ASU No. 2013-02 is effective for fiscal years beginning on or after December 15, 2012. The Bank does not expect this ASU to have an impact on its financial condition or results of operations as it affects presentation only.

**NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

**Adoption of new accounting standards (continued) –** In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement* (Topic 820), *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The ASU improves the comparability of fair value measurements presented and disclosed in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRSs) by changing the wording used to describe many of the requirements in U.S GAAP for measuring fair value and disclosure of information. The amendments to this ASU provide explanations on how to measure fair value, but do not require any additional fair value measurements and do not establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify existing fair value measurements and disclosure requirements to include application of the highest and best use and valuation premises concepts; measuring fair value of an instrument classified in a reporting entity's shareholders' equity; and disclosure requirements regarding quantitative information about unobservable inputs categorized within Level 3 of the fair value hierarchy. In addition, clarification is provided for measuring the fair value of financial instruments that are managed in a portfolio and the application of premiums and discounts in a fair value measurement. For non-public entities, ASU No. 2011-04 is effective for annual periods beginning after December 15, 2011. Our adoption of this ASU in 2012 did not have a significant impact on the Bank's financial statements.

## NOTE 2 – INVESTMENT SECURITIES

The amortized cost and estimated fair values of securities available-for-sale are as follows:

| 2012 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Available-for-sale: | | | | |
| U.S. government and agency securities | $ 34,959,031 | $ 772,279 | $ (5,401) | $ 35,725,909 |
| Mortgage-backed securities | 12,858,751 | 292,015 | (39,061) | 13,111,705 |
| State and municipal agencies | 11,041,561 | 127,097 | (107,324) | 11,061,334 |
| Corporate debt securities | 3,987,149 | 39,243 | (3,642) | 4,022,750 |
| | $ 62,846,492 | $ 1,230,634 | $ (155,428) | $ 63,921,698 |

| 2011 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| Available-for-sale: | | | | |
| U.S. government and agency securities | $ 43,692,819 | $ 627,822 | $ (16,151) | $ 44,304,490 |
| Mortgage-backed securities | 8,463,114 | 279,936 | (104) | 8,742,946 |
| State and municipal agencies | 1,097,560 | - | (2,314) | 1,095,246 |
| Corporate debt securities | 2,478,803 | - | (212,354) | 2,266,449 |
| | $ 55,732,296 | $ 907,758 | $ (230,923) | $ 56,409,131 |

The amortized cost and estimated fair value of all investment securities as of December 31, 2012 by expected maturities are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Due in one year or less | $ 219,955 | $ 220,926 |
| Due after one year to five years | 6,286,278 | 6,366,730 |
| Due from five years to ten years | 17,252,173 | 17,499,562 |
| Due after ten years | 39,088,086 | 39,834,480 |
| | $ 62,846,492 | $ 63,921,698 |

**NOTE 2 – INVESTMENT SECURITIES (CONTINUED)**

The gross unrealized loss and related estimated fair value of investment securities that have been in a continuous loss position for less than twelve months and over twelve months are as follows:

| 2012 | Less than 12 months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. government and agency securities | $ 2,127,899 | $ (2,568) | $ 2,232,125 | $ (2,833) | $ 4,360,024 | $ (5,401) |
| Mortgage-backed securities | 3,411,626 | (39,061) | - | - | 3,411,626 | (39,061) |
| State and municipal agencies | 6,207,056 | (107,324) | - | - | 6,207,056 | (107,324) |
| Corporate debt securities | - | - | 492,570 | (3,642) | 492,570 | (3,642) |
| | $ 11,746,581 | $ (148,953) | $ 2,724,695 | $ (6,475) | $ 14,471,276 | $ (155,428) |

| 2011 | Less than 12 months | | Over 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| U.S. government and agency securities | $ 10,771,367 | $ (16,151) | $ - | $ - | $ 10,771,367 | $ (16,151) |
| Mortgage-backed securities | 46,521 | (104) | - | - | 46,521 | (104) |
| State and municipal agencies | 1,095,245 | (2,314) | - | - | 1,095,245 | (2,314) |
| Corporate debt securities | 2,266,449 | (212,354) | - | - | 2,266,449 | (212,354) |
| | $ 14,179,582 | $ (230,923) | $ - | $ - | $ 14,179,582 | $ (230,923) |

Certain investment securities shown in the previous table currently have fair values less than amortized cost and therefore contain unrealized losses. The Bank considers a number of factors including, but not limited to: (a) the length of time and the extent to which the fair value has been less than the amortized cost, (b) the financial condition and near-term prospects of the issuer, (c) the intent and ability of the Bank to retain its investment for a period of time sufficient to allow for an anticipated recovery in value, (d) whether the debtor is current on interest and principal payments, and (e) general market conditions and the industry- or sector-specific outlook. Management has evaluated all securities at December 31, 2012 and 2011, and has determined that no securities are other than temporarily impaired.

## NOTE 2 – INVESTMENT SECURITIES (CONTINUED)

The Bank does not have the intent to sell the investments that are impaired, and it is more likely than not that the Bank will not be required to sell those investments before recovery of the amortized cost basis. 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 issuer- or industry-specific event. These temporary unrealized losses relate principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition. At December 31, 2012, there were 22 investment securities with unrealized losses. 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.

Proceeds from the sales of investment securities totaled $1,530,185 during the year ended December 31, 2012. Gross realized gains totaled $100,615 during 2012. There were no realized losses during 2012. No investment securities were sold during 2011.

Investment securities carried at approximately $1,242,000 and $2,055,000 at December 31, 2012 and 2011, respectively, were pledged to secure public deposits or other purposes as permitted or required by law.

## NOTE 3 – LOANS

Major classifications of loans are as follows:

| | DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| Commercial and industrial | $ 35,442,291 | $ 31,624,476 |
| Commercial real estate | 40,838,323 | 36,021,259 |
| Land and construction | 6,482,128 | 8,389,230 |
| Residential real estate | 15,288,968 | 14,360,561 |
| Agriculture | 10,636,805 | 9,560,586 |
| Consumer | 157,366 | 436,656 |
| | 108,845,881 | 100,392,768 |
| Allowance for loan losses | (2,498,139) | (2,792,619) |
| Deferred loan fees and costs, net | 116,759 | (251,628) |
| | $ 106,464,501 | $ 97,348,521 |

**NOTE 3 – LOANS (CONTINUED)**

The Bank's loan portfolio consists primarily of loans to borrowers within Fresno County, California. Although the Bank seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, real estate and real estate associated businesses are among the principal industries in the Bank's market area and, as a result, the Bank's loan and collateral portfolios are, to some degree, concentrated in those industries.

All of the Bank's loans are underwritten after evaluating the borrower's character and, for commercial and business loans, managerial and operational experience. Underwriting standards are designed to promote relationship banking rather than transactional banking.

Commercial and industrial loans are primarily made to commercial and business entities for working capital, equipment purchases, growth and expansion, and any other permissible purposes. The Bank's management examines current and projected cash flows to determine the ability of the borrower to repay its obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets such as equipment, accounts receivable, or inventory and may incorporate personal guarantees or personal assets as collateral; however, some loans may be made on an unsecured basis.

Commercial real estate loans are primarily made to owner-users of the property or investors with current tenants in the property. Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing the Bank's commercial real estate portfolio are diverse in terms of type and industries operating within the properties. This diversity helps reduce the Bank's exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on collateral type, geography, industry, and risk grade criteria.

Land and construction loans are primarily made to borrowers who are using the property for their own purposes. The Bank does not make speculative land loans where repayment will be from the eventual sale of the property to unknown parties. Land loans are made with amortizing repayment terms to borrowers with proven, historic cash flow sufficient to repay the loan. Collateral values are based on the current "as is" market value of the property. Construction loans are made based on the borrower's historic and projected cash flow. The Bank does not engage in speculative construction loans where repayment will come from the sale or lease of the property to unknown parties.

**NOTE 3 – LOANS (CONTINUED)**

Residential real estate loans are made to individuals for the purchase or refinance of residential 1-to-4 family properties or for other consumer purposes. Residential real estate loans are underwritten based upon income, credit history, and collateral. The Bank does not generate residential real estate loans for sale. To monitor and manage residential loan risk, policies and procedures are developed and modified, as needed. Underwriting standards for home loans are heavily influenced by statutory requirements, which include, but are not limited to, a determination and verification of borrower's ability to repay the loan, maximum loan-to-value percentage, collection remedies, and documentation requirements.

Agricultural loans are primarily made to producers of agricultural products. Agricultural loans are subject to underwriting standards and processes similar to commercial loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate and/or agricultural commodities. Agricultural real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Agricultural crop loans may be more adversely affected by conditions in the weather or in the general economy. The properties securing the Bank's agricultural portfolio are diverse in terms of type of crop. This diversity helps reduce the Bank's exposure to adverse economic events that affect any single commodity. Management monitors and evaluates agricultural real estate loans based on collateral, crop type, geography, and risk grade criteria.

Consumer loans are made to individuals for personal, household, and family expenditures and consist of term loans and lines of credit. The Bank does not offer credit card plans. Consumer loans are subject to underwriting standards and processes similar to residential real estate loans and are based primarily on income, credit history, and collateral; however, some consumer loans are unsecured. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This activity coupled with relatively small loan amounts that are spread across many individual borrowers minimizes risk.

The Bank utilizes an independent third party loan review consultant to review and validate the credit risk program on a periodic basis. Results of these reviews are presented to management and the Bank's Board of Directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.

## NOTE 3 – LOANS (CONTINUED)

Information related to impaired loans as of December 31, 2012 and for the year ended consisted of the following:

| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Residential Real Estate | Agriculture | Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Recorded investment in impaired loans:** | | | | | | | |
| With no specific allowance recorded | $ - | $ - | $ - | $ 74,746 | $ - | $ - | $ 74,746 |
| With a specific allowance recorded | 1,309,585 | 1,080,545 | - | - | - | - | 2,390,130 |
| Total recorded investment in impaired loans | $ 1,309,585 | $ 1,080,545 | $ - | $ 74,746 | $ - | $ - | $ 2,464,876 |
| **Unpaid principal balance of impaired loans:** | | | | | | | |
| With no specific allowance recorded | $ - | $ - | $ - | $ 74,746 | $ - | $ - | $ 74,746 |
| With a specific allowance recorded | 1,309,585 | 1,080,545 | - | - | - | - | 2,390,130 |
| Total unpaid principal balance of impaired loans | $ 1,309,585 | $ 1,080,545 | $ - | $ 74,746 | $ - | $ - | $ 2,464,876 |
| Specific allowance | $ 523,834 | $ 36,051 | $ - | $ - | $ - | $ - | $ 559,885 |
| Average recorded investment in impaired loans during the year | $ 454,846 | $ 1,355,294 | $ 1,933,508 | $ 155,046 | $ - | $ - | $ 3,898,694 |
| Interest income recognized on impaired loans during the year | $ 95,545 | $ 34,351 | $ 71,536 | $ 11,051 | $ - | $ - | $ 212,483 |

Information related to impaired loans as of December 31, 2011 and for the year ended consisted of the following:

| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Residential Real Estate | Agriculture | Consumer | Total |
|---|---|---|---|---|---|---|---|
| **Recorded investment in impaired loans:** | | | | | | | |
| With no specific allowance recorded | $ - | $ - | $ - | $ 90,323 | $ - | $ - | $ 90,323 |
| With a specific allowance recorded | - | 2,026,462 | 2,561,418 | 294,848 | - | - | 4,882,728 |
| Total recorded investment in impaired loans | $ - | $ 2,026,462 | $ 2,561,418 | $ 385,171 | $ - | $ - | $ 4,973,051 |
| **Unpaid principal balance of impaired loans:** | | | | | | | |
| With no specific allowance recorded | $ - | $ - | $ - | $ 90,323 | $ - | $ - | $ 90,323 |
| With a specific allowance recorded | - | 2,026,462 | 2,561,418 | 294,848 | - | - | 4,882,728 |
| Total unpaid principal balance of impaired loans | $ - | $ 2,026,462 | $ 2,561,418 | $ 385,171 | $ - | $ - | $ 4,973,051 |
| Specific allowance | $ - | $ 434,597 | $ 47,494 | $ 75,248 | $ - | $ - | $ 557,339 |
| Average recorded investment in impaired loans during the year | $ - | $ 2,351,021 | $ 1,286,563 | $ 392,273 | $ 237,826 | $ - | $ 4,267,683 |
| Interest income recognized on impaired loans during the year | $ - | $ 42,252 | $ 140,110 | $ 11,023 | $ 23,988 | $ - | $ 217,373 |

**NOTE 3 – LOANS (CONTINUED)**

The Bank has established a loan risk rating system to measure and monitor the quality of the loan portfolio. All loans are assigned a risk rating from the inception of the loan until the loan is paid off. The primary loan grades are as follows:

**Loans rated Pass –** These are loans to borrowers with satisfactory financial support, repayment capacity, and credit strength. Borrowers in this category demonstrate fundamentally sound financial positions, repayment capacity, credit history, and management expertise. Loans in this category must have an identifiable and stable source of repayment and meet the Bank's policy regarding debt service coverage ratios. These borrowers are capable of sustaining normal economic, market, or operational setbacks without significant financial impacts. Financial ratios and trends are acceptable. Negative external industry factors are generally not present. The loan may be secured, unsecured, or supported by non-real estate collateral for which the value is more difficult to determine and/or marketability is more uncertain. These loans carry a normal degree of risk. The borrowers have the capacity to perform according to terms; any deviation from historic performance is limited and temporary.

**Loans rated Special Mention –** These are loans that have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Special Mention assets are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification. These loans exhibit a more weakened condition than Pass loans, but not to the degree where they would be considered substandard. These loans show definite signs of deterioration or weakness, and the likelihood of correction is somewhat questionable. Weaknesses might include significant earnings decline, collection of accounts receivable is slowing, delayed accounts payable, greater dependency on-line usage, covenants not being met, and/or waived for short periods.

**Loans rated Substandard –** These are loans that are inadequately protected by the current sound worth and paying capacity of the borrower or by the collateral pledged, if any. These loans have a well-defined weakness, or weaknesses that jeopardize the liquidation of the loan. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

**Loans rated Doubtful –** These are loans that have all the weaknesses inherent in a loan classified as Substandard with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable, and improbable. These loans have a high probability of loss due to significant deterioration in financial condition of the borrower and collateral value pledged, if any. The borrower is unable to demonstrate the ability to strengthen their financial condition within a reasonable time; therefore, close supervision is required and the loan is placed on non-accrual. The risk of loss is measured by an impairment analysis; any loss exposure determined through this analysis is to be charged off.

**NOTE 3 – LOANS (CONTINUED)**

The following table summarizes the loan portfolio by credit quality and product and/or collateral type as of December 31, 2012:

| | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Grade: | | | | | |
| Commercial and industrial | $ 32,493,477 | $ - | $ 2,948,814 | $ - | $ 35,442,291 |
| Commercial real estate | 36,935,852 | 3,373,615 | 528,856 | - | 40,838,323 |
| Land and construction | 6,456,230 | - | 25,898 | - | 6,482,128 |
| Residential real estate | 14,919,461 | - | 369,507 | - | 15,288,968 |
| Agriculture | 10,636,805 | - | - | - | 10,636,805 |
| Consumer | 157,366 | - | - | - | 157,366 |
| | $ 101,599,191 | $ 3,373,615 | $ 3,873,075 | $ - | $ 108,845,881 |

The following table summarizes the loan portfolio by credit quality and product and/or collateral type as of December 31, 2011:

| | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Grade: | | | | | |
| Commercial and industrial | $ 28,842,637 | $ 194,000 | $ 2,587,839 | $ - | $ 31,624,476 |
| Commercial real estate | 29,761,942 | 3,448,964 | 2,810,353 | - | 36,021,259 |
| Land and construction | 5,797,670 | - | 2,591,560 | - | 8,389,230 |
| Residential real estate | 13,627,890 | - | 732,671 | - | 14,360,561 |
| Agriculture | 9,560,586 | - | - | - | 9,560,586 |
| Consumer | 436,656 | - | - | - | 436,656 |
| | $ 88,027,381 | $ 3,642,964 | $ 8,722,423 | $ - | $ 100,392,768 |

## NOTE 3 – LOANS (CONTINUED)

The following table is an aging analysis of loans, segregated by class of loans, as of December 31, 2012:

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| Commercial and industrial | $ 10,441 | $ 249,551 | $ 282,572 | $ 542,564 | $ 34,899,727 | $ 35,442,291 | $ 282,572 |
| Commercial real estate | - | - | - | - | 40,838,323 | 40,838,323 | - |
| Land and construction | - | - | - | - | 6,482,128 | 6,482,128 | - |
| Residential real estate | - | - | - | - | 15,288,968 | 15,288,968 | - |
| Agriculture | - | - | - | - | 10,636,805 | 10,636,805 | - |
| Consumer | - | - | - | - | 157,366 | 157,366 | - |
| Total | $ 10,441 | $ 249,551 | $ 282,572 | $ 542,564 | $108,303,317 | $ 108,845,881 | $ 282,572 |

The following table is an aging analysis of loans, segregated by class of loans, as of December 31, 2011:

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| Commercial and industrial | $ 43,740 | $ - | $ - | $ 43,740 | $ 31,580,736 | $ 31,624,476 | $ - |
| Commercial real estate | - | 795,299 | - | 795,299 | 35,225,960 | 36,021,259 | - |
| Land and construction | 30,142 | - | - | 30,142 | 8,359,088 | 8,389,230 | - |
| Residential real estate | - | - | - | - | 14,360,561 | 14,360,561 | - |
| Agriculture | - | - | - | - | 9,560,586 | 9,560,586 | - |
| Consumer | - | - | - | - | 436,656 | 436,656 | - |
| Total | $ 73,882 | $ 795,299 | $ - | $ 869,181 | $ 99,523,587 | $ 100,392,768 | $ - |

**NOTE 3 – LOANS (CONTINUED)**

The following tables summarize loans to customers whose loan terms were modified in troubled debt restructurings during the following years ended December 31:

| | Year Ended December 31, 2012 | | |
|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| **Troubled Debt Restructurings** | | | |
| Commercial and industrial | 2 | $ 1,309,585 | $ 1,309,585 |
| Commercial real estate | - | - | - |
| Land and construction | - | - | - |
| Residential real estate | - | - | - |
| Agriculture | - | - | - |
| Consumer | - | - | - |
| | 2 | $ 1,309,585 | $ 1,309,585 |

| | Year Ended December 31, 2011 | | |
|---|---|---|---|
| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| **Troubled Debt Restructurings** | | | |
| Commercial and industrial | - | $ - | $ - |
| Commercial real estate | - | - | - |
| Land and construction | 2 | 2,105,388 | 2,105,388 |
| Residential real estate | - | - | - |
| Agriculture | - | - | - |
| Consumer | - | - | - |
| | 2 | $ 2,105,388 | $ 2,105,388 |

The loans outlined above are considered troubled debt restructuring because the Bank granted a concession to a borrower experiencing financial difficulties that it would not otherwise consider. During 2012, there were two loans to one borrower that were modified and considered troubled debt restructurings because specific payment term concessions were granted to the borrower. The two troubled debt restructurings for the borrower subsequently defaulted after restructuring and were placed on non-accrual as of December 31, 2012. During 2011, there were two loans to one borrower that were modified and considered troubled debt restructurings because specific interest rate concessions were granted to the borrower.

**NOTE 3 – LOANS (CONTINUED)**

In 2012, two troubled debt restructurings from 2011 defaulted after restructuring and were subsequently transferred to other real estate owned. In 2011, one troubled debt restructuring from 2010 with a principal balance of $795,299 defaulted. The Bank has not committed to lend any additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

Year end non-accrual loans, segregated by class, are as follows:

| | DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| Commercial and industrial | $ 1,309,585 | $ - |
| Commercial real estate | - | 795,299 |
| Land and construction | - | - |
| Residential real estate | 74,746 | 90,323 |
| Agriculture | - | - |
| Consumer | - | - |
| | $ 1,384,331 | $ 885,622 |

**NOTE 3 – LOANS (CONTINUED)**

The following table summarizes the Bank’s allowance for loan losses for the year ended December 31, 2012 by loan product and collateral type:

| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Residential Real Estate | Agriculture | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | | | |
| Beginning balance | $ 1,142,549 | $ 771,406 | $ 175,654 | $ 242,698 | $ 71,259 | $ 1,608 | $ 387,445 | $ 2,792,619 |
| Charge-offs | (256,380) | (432,932) | (392,927) | - | - | (2,241) | - | (1,084,480) |
| Recoveries | 7,000 | - | - | - | - | - | - | 7,000 |
| Provision | 532,484 | 101,579 | 302,134 | (72,776) | (12,672) | 1,431 | (69,180) | 783,000 |
| Ending balance | $ 1,425,653 | $ 440,053 | $ 84,861 | $ 169,922 | $ 58,587 | $ 798 | $ 318,265 | $ 2,498,139 |
| Period-end amount allocated to: | | | | | | | | |
| Loans individually evaluated for impairment | $ 523,834 | $ 36,051 | $ - | $ - | $ - | $ - | $ - | $ 559,885 |
| Loans collectively evaluated for impairment | 901,819 | 404,002 | 84,861 | 169,922 | 58,587 | 798 | 318,265 | 1,938,254 |
| Ending balance | $ 1,425,653 | $ 440,053 | $ 84,861 | $ 169,922 | $ 58,587 | $ 798 | $ 318,265 | $ 2,498,139 |
| Loans: | | | | | | | | |
| Individually evaluated for impairment | $ 1,309,585 | $ 1,080,545 | $ - | $ 74,746 | $ - | $ - | | $ 2,464,876 |
| Collectively evaluated for impairment | 34,132,706 | 39,757,778 | 6,482,128 | 15,214,222 | 10,636,805 | 157,366 | | 106,381,005 |
| Ending balance | $ 35,442,291 | $ 40,838,323 | $ 6,482,128 | $ 15,288,968 | $ 10,636,805 | $ 157,366 | | $108,845,881 |

**NOTE 3 – LOANS (CONTINUED)**

The following table summarizes the Bank's allowance for loan losses for the year ended December 31, 2011 by loan product and collateral type:

| | Commercial and Industrial | Commercial Real Estate | Land and Construction | Residential Real Estate | Agriculture | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | | | |
| Beginning balance | $ 615,005 | $ 830,346 | $ 296,611 | $ 281,281 | $ 59,983 | $ 13,393 | $ 282,502 | $ 2,379,121 |
| Charge-offs | (86,902) | - | - | - | - | - | - | (86,902) |
| Recoveries | 400 | - | - | - | - | - | - | 400 |
| Provision | 614,046 | (58,940) | (120,957) | (38,583) | 11,276 | (11,785) | 104,943 | 500,000 |
| Ending balance | $ 1,142,549 | $ 771,406 | $ 175,654 | $ 242,698 | $ 71,259 | $ 1,608 | $ 387,445 | $ 2,792,619 |
| Period-end amount allocated to: | | | | | | | | |
| Loans individually evaluated for impairment | $ - | $ 434,597 | $ 47,494 | $ 75,248 | $ - | $ - | $ - | $ 557,339 |
| Loans collectively evaluated for impairment | 1,142,549 | 336,809 | 128,160 | 167,450 | 71,259 | 1,608 | 387,445 | 2,235,280 |
| Ending balance | $ 1,142,549 | $ 771,406 | $ 175,654 | $ 242,698 | $ 71,259 | $ 1,608 | $ 387,445 | $ 2,792,619 |
| Loans: | | | | | | | | |
| Individually evaluated for impairment | $ - | $ 2,026,462 | $ 2,561,418 | $ 385,171 | $ - | $ - | | $ 4,973,051 |
| Collectively evaluated for impairment | 31,624,476 | 33,994,797 | 5,827,812 | 13,975,390 | 9,560,586 | 436,656 | | 95,419,717 |
| Ending balance | $ 31,624,476 | $ 36,021,259 | $ 8,389,230 | $ 14,360,561 | $ 9,560,586 | $ 436,656 | | $100,392,768 |

**NOTE 4 – PREMISES AND EQUIPMENT**

A summary of premises and equipment as of December 31 follows:

| | DECEMBER 31, 2012 | DECEMBER 31, 2011 |
|---|---|---|
| Leasehold improvements | $ 1,123,897 | $ 1,123,897 |
| Furniture, fixtures, and equipment | 469,958 | 469,958 |
| Computer equipment | 630,536 | 555,726 |
| | 2,224,391 | 2,149,581 |
| Less accumulated depreciation and amortization | (1,752,585) | (1,549,144) |
| | $ 471,806 | $ 600,437 |

The Bank has entered into a ten-year lease for its main banking and administrative offices. The Bank is responsible for common area maintenance, taxes, and insurance to the extent they exceed the base year amounts. The lease expires on January 31, 2016.

At December 31, 2012, the future lease rental payable under non-cancellable operating lease commitments for the Banks' main and administrative offices were as follows:

| | |
|---|---|
| 2013 | $ 303,676 |
| 2014 | 312,028 |
| 2015 | 321,388 |
| 2016 | 26,848 |
| Thereafter | - |
| | $ 963,940 |

The minimum rental payments shown above are given for the existing lease obligations and are not a forecast of future rental expense. Total rental expense was approximately $277,000 and $301,000 for the years ended December 31, 2012 and 2011, respectively.

**NOTE 5 – DEPOSITS**

Customer deposits were as follows:

| | DECEMBER 31, | |
|---|---|---|
| | 2012 | 2011 |
| Non-interest-bearing demand | $ 64,385,021 | $ 48,155,031 |
| Savings, NOW, and money market accounts | 79,469,098 | 62,427,469 |
| Time deposits under $100,000 | 13,786,217 | 15,484,463 |
| Time deposits $100,000 and over | 28,806,991 | 32,707,375 |
| | $ 186,447,327 | $ 158,774,338 |

At December 31, 2012, the scheduled maturities of time deposits are as follows:

| | |
|---|---|
| 2013 | $ 37,176,372 |
| 2014 | 3,150,977 |
| 2015 | 1,783,240 |
| 2016 | 233,619 |
| 2017 and beyond | 249,000 |
| | $ 42,593,208 |

**NOTE 6 – BORROWING ARRANGEMENTS**

The Bank may borrow up to $12,000,000 overnight on an unsecured basis from three correspondent banks. The Bank may also borrow up to approximately $29,256,000 from the Federal Home Loan Bank of San Francisco, subject to providing collateral and fulfilling other conditions of the credit facility. The Bank has pledged investment securities of approximately $1,242,000 for the credit facility at Federal Home Loan Bank of San Francisco. The Bank may also borrow from the Federal Reserve Bank of San Francisco, subject to fulfilling other conditions of the credit facility and providing collateral. As of December 2012 and 2011, no amounts were outstanding under these arrangements.

**NOTE 7 – EMPLOYEE BENEFITS**

The Bank sponsors an employee stock ownership plan (ESOP) for eligible employees. Eligibility begins after an employee has attained the age of 21 and completed one year of service, as defined in the ESOP documents. Under the ESOP, the Bank contributes a discretionary amount to the ESOP for the purchase of the Bank's stock, to be held in trust for each participant to later be distributed in accordance with the ESOP. For the years ended December 31, 2012 and 2011, contributions to the ESOP were $152,928 and $150,000, respectively.

The Bank sponsors a 401(k) plan for the benefit of its employees. The Bank can match employee contributions and make additional contributions as determined by the Board of Directors annually. The Bank made no contributions for the years ended December 31, 2012 and 2011.

**NOTE 8 – INCOME TAXES**

The provision (benefit) for income taxes for the years ended December 31 consists of the following:

| | 2012 | 2011 |
|---|---|---|
| Current | | |
| Federal | $ 494,000 | $ 358,000 |
| State | 62,000 | 151,000 |
| | 556,000 | 509,000 |
| Deferred | | |
| Federal | 89,000 | (729,000) |
| State | 167,000 | (124,000) |
| | 256,000 | (853,000) |
| | $ 812,000 | $ (344,000) |

Deferred taxes are a result of differences between income tax accounting and generally accepted accounting principles with respect to income and expense recognition.

## NOTE 8 – INCOME TAXES (CONTINUED)

The following is a summary of the components of the net deferred tax asset accounts recognized in the accompanying statements of financial condition at December 31:

| | 2012 | 2011 |
|---|---|---|
| Deferred tax assets: | | |
| Pre-operating expenses | $ 137,000 | $ 154,000 |
| Depreciation differences | 214,000 | 170,000 |
| Allowance for loan losses due to tax limitations | 772,000 | 1,008,000 |
| Stock-based compensation | 274,000 | 274,000 |
| Operating loss carryforwards | 294,000 | 383,000 |
| Other | 163,000 | 135,000 |
| | 1,854,000 | 2,124,000 |
| Deferred tax liabilities: | | |
| Accrual to cash | (52,000) | (104,000) |
| Unrealized gains on available-for-sale securities | (441,000) | (278,000) |
| Other | (100,000) | (62,000) |
| | (593,000) | (444,000) |
| Valuation allowance | (66,000) | (66,000) |
| Net deferred income tax asset | $ 1,195,000 | $ 1,614,000 |

As of December 31, 2012 and 2011, a valuation allowance of $66,000 was recorded for both years equal to the amount of deferred tax assets for certain non-qualified stock options the Bank determined are more likely than not unable to be realized before those options expire. The Bank reduced the valuation allowance by approximately $929,000 in 2011. The Bank has net operating loss carryforwards of approximately $2,243,000 for California franchise tax purposes. California net operating loss carryforwards, to the extent not used, will begin to expire in 2028.

The Bank is subject to federal income tax and franchise tax of the state of California. Income tax returns for the years ended December 31, 2012, 2011, and 2010 are open to audit by the federal authorities and income tax returns for the years ended December 31, 2012, 2011, 2010, 2009, and 2008 are open to audit by state authorities. Unrecognized tax benefits are not expected to significantly increase or decrease within the next twelve months.

**NOTE 9 – RELATED PARTY TRANSACTIONS**

In the ordinary course of business, the Bank has granted loans to certain directors and their related interests with which they are associated. The balance of these loans outstanding was approximately $1,238,000 and $1,479,000 at December 31, 2012 and 2011, respectively.

Deposits from certain directors, officers, and their related interests with which they are associated, held by the Bank at December 31, 2012 and 2011 amounted to approximately $2,672,000 and $2,853,000, respectively.

**NOTE 10 – EARNINGS PER SHARE (EPS)**

Earnings per share for the years ended December 31 were computed as follows:

| | 2012 | 2011 |
|---|---|---|
| Basic earnings per share: | | |
| Net income | $ 1,170,688 | $ 1,916,172 |
| Accretion of Series A and B preferred stocks | (2,722) | (32,667) |
| Dividends paid on Series A and B preferred stocks | (103,050) | (107,220) |
| Net income available to common shareholders | $ 1,064,916 | $ 1,776,285 |
| Weighted average common shares outstanding | 1,779,748 | 1,860,111 |
| Basic earnings per share | $ 0.60 | $ 0.95 |
| Diluted earnings per share: | | |
| Net income | $ 1,170,688 | $ 1,916,172 |
| Accretion of Series A and B preferred stocks | (2,722) | (32,667) |
| Dividends paid on Series A and B preferred stocks | (103,050) | (107,220) |
| Net income available to common shareholders | $ 1,064,916 | $ 1,776,285 |
| Weighted average common shares outstanding | 1,779,748 | 1,860,111 |
| Effect of dilutive stock options | 1,467 | 639 |
| Incremental shares from assumed conversion of Series C convertible preferred stock | 640,500 | - |
| Adjusted weighted average common shares outstanding | 2,421,715 | 1,860,750 |
| Diluted earnings per share | $ 0.44 | $ 0.95 |

At December 31, 2012 and 2011, there were 502,659 and 454,701 stock options, respectively, that could potentially dilute earnings per share in the future that were not included in the computation of diluted earnings per share because to do so would have been antidilutive. All income per share amounts have been retroactively adjusted for the effect of stock dividends.

## NOTE 11– COMMITMENTS

In the ordinary course of business, the Bank enters into financial commitments to meet the financing needs of its customers. These financial commitments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk not recognized in the Bank's financial statements.

The Bank's exposure to loan loss in the event of non-performance on 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 as it does for loans reflected in the financial statements.

As of December 31, 2012 and 2011, the Bank had the following outstanding financial commitments whose contractual amount represents credit risk:

| | 2012 | 2011 |
|---|---|---|
| Commitments to extend credit | $ 30,760,000 | $ 21,380,000 |
| Letters of credit | - | - |
| | $ 30,760,000 | $ 21,380,000 |

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. Since many of the commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements. The Bank evaluates each client's credit worthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Bank is based on management's credit evaluation of the customer. The majority of the Bank's commitments to extend credit and standby letters of credit are secured by real estate.

## NOTE 12 – STOCK OPTION PLAN

The Bank's 2005 Equity Based Compensation Plan (the Plan) was approved by its shareholders in February 2006. Under the terms of the 2005 the Plan, officers and key employees may be granted both non-qualified, incentive stock options and restricted stock awards and directors, who are not also an officer or employee, may only be granted nonqualified stock options and restricted stock awards. The Plan provides for a maximum number of shares that may be awarded to eligible employees and directors not to exceed 495,000 shares. In July 2012, the shareholders approved an additional 183,000 shares to be added to the Plan increasing the total to 678,000 shares. Stock options are granted at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than ten years from the date of the grant and all equity-based awards generally vest over three years. The Plan provides for accelerated vesting if there is a change of control, as defined in the Plan. The Bank recognized stock based compensation cost of $62,795 and $77,384 in 2012 and 2011, respectively. The Bank recognized tax expense related to stock-based compensation of $-0- and $11,859 in 2012 and 2011, respectively.

**NOTE 12 – STOCK OPTION PLAN (CONTINUED)**

The following table shows weighted average assumptions used in valuing stock options granted for the years ended December 31:

| | 2012 | 2011 |
|---|---|---|
| Expected volatility | 25.30% | 36.43% |
| Expected term | 6.5 years | 6.5 years |
| Expected dividends | None | None |
| Risk free rate | 1.07% | 1.98% |
| Grant date fair value | $ 1.32 | $ 2.62 |

Since the Bank has a limited amount of historical stock activity, the expected volatility is based on the historical volatility of similar banks that have a longer trading history. The expected term represents the estimated average period of time that the options remain outstanding. Since the Bank does not have sufficient historical data on the exercise of stock options, the expected term is based on the "simplified" method that measures the expected term as the average of the vesting period and the contractual term. The risk free rate of return reflects the grant date interest rate offered for U.S. Treasury bonds over the expected term of the options.

A summary of the status of stock options that have been granted by the Bank as of December 31, 2012, and changes during the year ending thereon is presented below:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at beginning of year | 478,076 | $ 9.65 | | |
| Granted | 29,400 | $ 8.71 | | |
| Exercised | (3,859) | $ 6.85 | | |
| Forfeited or expired | (97) | $ 7.71 | | |
| Outstanding at end of year | 503,520 | $ 9.61 | 4.8 years | None |
| Options exercisable | 447,404 | $ 9.73 | 4.0 years | None |

As of December 31, 2012, there was approximately $73,000 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted average period of 1.7 years.

## NOTE 13 – REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet these 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.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) 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, 2012, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2012, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action (there are no conditions or events since that notification that management believes have changed the Bank's category). To be categorized as well capitalized, the Bank must maintain minimum ratios as set forth in the table below. The following table also sets forth the Bank's actual capital amounts and ratios (dollar amounts in thousands):

| | Actual | | For capital adequacy purposes | | To be well-capitalized under prompt corrective action provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2012: | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 23,999 | 22.2% | $ 8,644 | ≥ 8.0% | $ 10,805 | ≥ 10.0% |
| Tier I Capital (to Risk-Weighted Assets) | $ 22,634 | 20.9% | $ 4,322 | ≥ 4.0% | $ 6,483 | ≥ 6.0% |
| Tier I Capital (to Average Assets) | $ 22,634 | 10.8% | $ 8,349 | ≥ 4.0% | $ 10,436 | ≥ 5.0% |
| December 31, 2011: | | | | | | |
| Total Capital (to Risk-Weighted Assets) | $ 18,797 | 19.5% | $ 7,695 | ≥ 8.0% | $ 9,619 | ≥ 10.0% |
| Tier I Capital (to Risk-Weighted Assets) | $ 17,574 | 18.3% | $ 3,848 | ≥ 4.0% | $ 5,771 | ≥ 6.0% |
| Tier I Capital (to Average Assets) | $ 17,574 | 10.2% | $ 6,909 | ≥ 4.0% | $ 8,636 | ≥ 5.0% |

**NOTE 13 – REGULATORY MATTERS (CONTINUED)**

The California Financial Code provides that a bank may not make a cash distribution to its shareholders in excess of the lessor of the bank's undivided profits or the bank's net income for its last three fiscal years less any distributions made to shareholders during the same period without the approval in advance of the Commissioner of the California Department of Financial Institutions. Pursuant to the terms of the Bank's participation in the Troubled Assets Relief Program (TARP) Capital Purchase Program (see Note 16), the Bank's ability to declare or pay dividends on any of their shares is limited by the U.S. Treasury. See Note 10 for payment of dividends on the preferred stock related to the Bank's participation in the TARP Capital Purchase Program. The Bank redeemed the preferred shares that were part of the TARP Capital Purchase Program (see Note 16). With the redemption of the preferred shares from the U.S. Treasury, the Bank concluded its participation in the TARP Capital Purchase Program.

**NOTE 14 – FAIR VALUE MEASUREMENT**

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

**Securities –** The fair values of securities available-for-sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1) or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities, but rather by relying on the securities' relationship to other benchmark securities (Level 2).

**Collateral-dependent impaired loans –** The Bank does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect: (1) partial write-downs, through charge offs or specific reserve allowances, that are based on the current appraised or market-quoted value of the underlying collateral or (2) the full charge off of the loan carrying value. In some cases, the properties for which market quotes or appraisal values have been obtained are located in areas where comparable sales data is limited, outdated, or unavailable. Fair value estimates for collateral-dependent impaired loans are obtained from real estate brokers or other third-party consultants (Level 3).

**Other real estate owned –** The Bank utilizes current appraisals discounted for estimated selling costs to arrive at the estimate of fair value for all other real estate owned (Level 3).

## NOTE 14 – FAIR VALUE MEASUREMENT (CONTINUED)

The following table summarizes the Bank's assets that were measured at fair value on a recurring and non-recurring basis at December 31, 2012:

| Description of Assets | December 31, 2012 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Securities available-for-sale (recurring) | | | | |
| U.S. government and agency securities | $ 35,725,909 | $ - | $ 35,725,909 | $ - |
| Mortgage-backed securities | 13,111,705 | - | 13,111,705 | - |
| State and municipal agencies | 11,061,334 | - | 11,061,334 | - |
| Corporate debt securities | 4,022,750 | - | 4,022,750 | - |
| Other real estate owned (non-recurring) | 2,223,493 | - | - | 2,223,493 |
| Total | $ 66,145,191 | $ - | $ 63,921,698 | $ 2,223,493 |

The following table summarizes the Bank's assets that were measured at fair value on a recurring and non-recurring basis at December 31, 2011:

| Description of Assets | December 31, 2011 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Securities available-for-sale (recurring) | | | | |
| U.S. government and agency securities | $ 44,304,490 | $ - | $ 44,304,490 | $ - |
| Mortgage-backed securities | 8,742,946 | - | 8,742,946 | - |
| State and municipal agencies | 1,095,246 | - | 1,095,246 | - |
| Corporate debt securities | 2,266,449 | - | 2,266,449 | - |
| Impaired loans (non-recurring) | 745,875 | - | - | 745,875 |
| Total | $ 57,155,006 | $ - | $ 56,409,131 | $ 745,875 |

**NOTE 15 – FAIR VALUE OF FINANCIAL INSTRUMENTS**

The fair value of a financial instrument is the amount at which the asset or obligation could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the entire holdings of a particular financial instrument. Because no market value exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on financial instruments both on and off the balance sheet without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Additionally, tax consequences related to the realization of the unrealized gains and losses can have a potential effect on fair value estimates and have not been considered in many of the estimates.

The following methods and assumptions were used by the Bank in estimating fair values of financial instruments:

**Financial assets –** The carrying amounts of cash, short-term investments, due from customers on acceptances, and bank acceptances outstanding are considered to approximate fair value. Short-term investments include federal funds sold, securities purchased under agreements to resell, and interest bearing deposits with banks. The fair values of investment securities, including available for sale and held to maturity, are generally based on quoted market prices. The fair value of variable loans that reprice frequently and that have experienced no significant change in credit risk is based on carrying values. The fair values for all other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. Loans are generally expected to be held to maturity and any unrealized gains or losses are not expected to be realized. Fair value for Federal Home Loan Bank stock and interest receivable approximates its carrying value.

**Financial liabilities –** The carrying amounts of deposit liabilities payable on demands, commercial paper, and other borrowed funds are considered to approximate fair value. For fixed maturity deposits, fair value is estimated by discounting estimated future cash flows using currently offered rates for deposits of similar remaining maturities. The fair value of interest payable approximates its carrying amount.

## NOTE 15 – FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

**Off-balance sheet financial instruments –** The fair value of commitments to extend credit and standby letters of credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the counterparties.

The estimated fair value of financial instruments at December 31 is summarized as follows (in thousands):

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Fair Value Hierarchy | Carrying Amount | Estimated Fair Value | Fair Value Hierarchy |
| **Financial assets:** | | | | | | |
| Cash and cash equivalents | $ 32,858 | $ 32,858 | Level 1 | $ 19,664 | $ 19,664 | Level 1 |
| Securities available-for-sale | 63,922 | 63,922 | Level 2 | 56,409 | 56,409 | Level 2 |
| Loans, net | 106,465 | 111,282 | Level 3 | 97,349 | 101,533 | Level 3 |
| Federal Home Loan Bank stock | 942 | 942 | Level 2 | 781 | 781 | Level 2 |
| Interest receivable | 886 | 886 | Level 2 | 724 | 724 | Level 2 |
| **Financial liabilities:** | | | | | | |
| Deposits | 186,447 | 186,860 | Level 2 | 158,774 | 159,218 | Level 2 |
| Interest payable | 31 | 31 | Level 2 | 35 | 35 | Level 2 |
| **Off-balance-sheet liabilities:** | | | | | | |
| Commitments to extend credit and letters of credit | - | 308 | Level 3 | - | 214 | Level 3 |

## NOTE 16 – PREFERRED STOCK

On January 23, 2009, the Bank, in connection with the Troubled Assets Relief Program (TARP) Capital Purchase Program, entered into a Purchase Agreement with the United States Department of the Treasury (the Treasury), pursuant to which the Bank issued 1,968 shares of the Bank's Preferred Stock as Fixed Rate Non-cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock) and 98 shares of Fixed Rate Non-cumulative Perpetual Warrant Preferred Stock, Series B (the Series B Preferred Stock) for an aggregate purchase price of $1,968,000 in cash. Series A Preferred Stock pays non-cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. Series B Preferred Stock pays non-cumulative dividends at a rate of 9% per annum. In November 2012, the Bank redeemed 1,968 shares of Series A Preferred Stock for $1,000 per share and 98 shares of Series B Preferred Stock for $1,000 per share from the U.S Treasury. The total redemption price was $2,066,000. With the redemption of all outstanding shares of its Series A and Series B Preferred Stocks from the U.S. Treasury, the Bank concluded its participation in the TARP Capital Purchase Program (see Note 13).

**NOTE 16 – PREFERRED STOCK (CONTINUED)**

During 2012, the Bank issued 61,000 shares of Series C mandatorily convertible non-cumulative perpetual Preferred Stock at a price of $100.00 per share. Series C Preferred Stock pays non-cumulative dividends at 5% per annum and is mandatorily convertible to shares of common stock at a conversion price of $10.00 per share the day after the third anniversary of the issuance of the Series C Preferred Stock. This will result in the receipt of 10 shares of common stock for each share of Series C Preferred Stock. Prior to that time, the Series C Preferred Stock is convertible into the Bank's common stock at the election of the holder at the same $10.00 per share conversion price. In the event of a stock split, reverse stock split, stock dividend, reorganization, or recapitalization affecting the number of shareholders of the common stock outstanding, the conversion ratio shall be proportionately revised to preserve the conversion rights of the Series C Preferred Stock. Offering costs associated with this capital campaign totaled $384,962. Total proceeds, net of related offering costs, totaled $5,715,038.

**NOTE 17 – SUBSEQUENT EVENTS**

The Bank has evaluated the effects of subsequent events that have occurred after the period ending December 31, 2012 and through March 15, 2013, which is the date the financial statements were issued.

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# Corporate Information

**Annual Meeting of Shareholders**
Tuesday, June 18, 2013 at 5:30 pm
Fort Washington Country Club
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Fresno, CA  93730

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