

**BUSINESS BANK
BURLINGTON, WASHINGTON
AUDITED FINANCIAL STATEMENTS**

DECEMBER 31, 2009 AND 2008

BUSINESS BANK

C O N T E N T S

	PAGE
AUDITED FINANCIAL STATEMENTS:	
Independent Auditor's Report	1
Balance Sheets.....	2
Statements of Operations.....	3
Statements of Changes in Shareholders' Equity.....	4
Statements of Cash Flows	5
Notes to Financial Statements	6



INDEPENDENT AUDITOR'S REPORT

500 W. 7th Street
Suite 900
Fort Worth, Texas
76102-4702

Phone 817-632-2500
Fax 817-632-2598

www.sga-cpas.com

To the Board of Directors
of Business Bank
Burlington, Washington

We have audited the accompanying balance sheets of Business Bank as of December 31, 2009 and 2008, and the related statements of operations, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Business Bank as of December 31, 2009 and 2008, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming the Bank will continue as a going concern. As discussed in Note 2 to the financial statements, the Bank has incurred significant losses during 2009 and 2008 due to asset quality issues. As a result of these losses, the Bank has entered into agreements with the FDIC and State of Washington Department of Financial Institutions to address regulatory issues. Failure to address these regulatory issues may expose the Bank to additional regulatory sanctions. These matters cause substantial doubt about the Bank's ability to continue as a going concern. Management's plan regarding these matters is also described in Note 2. The accompanying financial statements do not include any adjustments that would be necessary should the Bank be unable to continue as a going concern.

Stovall, Grandey & Allen, LLP

STOVALL, GRANDEY & ALLEN, L.L.P.
Fort Worth, Texas
May 21, 2010

**BUSINESS BANK
BALANCE SHEETS
DECEMBER 31, 2009 AND 2008**

	<u>2009</u>	<u>2008</u>
ASSETS		
Cash and due from banks	\$ 1,517,381	\$ 2,597,832
Interest-bearing deposits with financial institutions	1,677,520	89,072
Federal funds sold	<u>7,010,000</u>	<u>-</u>
Cash and cash equivalents	10,204,901	2,686,904
Investment securities - Note 4	17,923,860	5,463,806
Federal Home Loan Bank stock, at cost - Note 3	1,074,300	1,010,000
Pacific Coast Bankers' Bank stock, at cost - Note 3	190,000	190,000
Loans held-for-sale	208,000	65,500
Loans receivable, net of allowance for loan losses and deferred loan fees - Note 5	81,667,086	111,173,825
Other real estate owned	5,554,348	434,544
Premises and equipment, net - Note 6	2,989,608	3,220,106
Accrued interest receivable	377,774	414,562
Federal income tax refund receivable - Note 8	-	597,867
Deferred tax asset - Note 8	-	455,379
Other assets	<u>141,302</u>	<u>99,452</u>
Total Assets	<u><u>\$120,331,179</u></u>	<u><u>\$125,811,945</u></u>
LIABILITIES		
Deposits - Note 7	\$ 92,898,932	\$ 88,635,383
Federal Home Loan Bank borrowings - Note 10	19,000,000	23,000,000
Short-term borrowings - Note 11	-	440,000
Accrued interest payable	254,866	224,044
Other liabilities	<u>244,476</u>	<u>151,065</u>
Total Liabilities	<u>112,398,274</u>	<u>112,450,492</u>
Commitments and contingencies - Notes 11, 12 and 13		
SHAREHOLDERS' EQUITY - Notes 14, 15 and 16		
Common stock, no par value; 5,000,000 shares authorized; 1,577,014 shares outstanding at December 31, 2009 and 1,395,163 shares outstanding at December 31, 2008	15,551,344	14,987,056
Additional paid-in capital	69,782	44,262
Retained deficit	(7,829,593)	(1,780,028)
Accumulated other comprehensive income, net of tax in 2008	<u>141,372</u>	<u>110,163</u>
Total Shareholders' Equity	<u>7,932,905</u>	<u>13,361,453</u>
Total Liabilities and Shareholders' Equity	<u><u>\$120,331,179</u></u>	<u><u>\$125,811,945</u></u>

The accompanying notes are an integral part of these financial statements.

BUSINESS BANK
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	<u>2009</u>	<u>2008</u>
Interest income		
Interest and fees on loans	\$ 6,212,105	\$ 7,849,245
Interest on investment securities	725,007	328,460
Interest on federal funds sold	11,806	51,068
Total interest income	<u>6,948,918</u>	<u>8,228,773</u>
Interest expense		
On deposits	2,577,170	3,281,707
On borrowed funds	629,618	546,017
Total interest expense	<u>3,206,788</u>	<u>3,827,724</u>
Net interest income	3,742,130	4,401,049
Provision for loan losses - Note 5	<u>5,000,979</u>	<u>2,839,435</u>
Net interest income (expense) after provision for loan losses	<u>(1,258,849)</u>	<u>1,561,614</u>
Non-interest income		
Service charges on deposit accounts	122,232	83,527
Gain (loss) on sale of investments	20,960	(470,994)
Loss on sale of other real estate owned	(230,852)	-
Gain on sale of loans	451,840	281,296
Other	14,623	-
Total non-interest income (expense)	<u>378,803</u>	<u>(106,171)</u>
Non-interest expense		
Salaries and employee benefits	2,131,075	2,250,935
Occupancy and equipment	623,382	572,683
Data processing fees	177,225	145,851
Professional fees	162,181	83,644
Advertising and marketing expenses	49,180	73,311
FDIC assessment	366,735	71,713
OREO expense and write downs	480,674	40,006
Unreimbursed loan expense	241,274	49,928
Other expense	429,627	446,205
Total non-interest expense	<u>4,661,353</u>	<u>3,734,276</u>
Loss before income taxes	(5,541,399)	(2,278,833)
Federal income tax (benefit) - Note 8	<u>508,166</u>	<u>(504,763)</u>
Net Loss	<u>\$ (6,049,565)</u>	<u>\$ (1,774,070)</u>

The accompanying notes are an integral part of these financial statements.

BUSINESS BANK
STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	<u>Shares of Common Stock</u>	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income</u>	<u>Total</u>
Balance at January 1, 2008	1,383,508	\$ 14,803,886	\$ 19,040	\$ (5,958)	\$ 39,293	\$ 14,856,261
Vesting of restricted common stock		20,000				20,000
Stock-based compensation, stock options			25,222			25,222
Sales of common stock	11,655	163,170				163,170
Net loss for the year ended December 31, 2008				(1,774,070)		(1,774,070)
Unrealized gain on available-for- sale securities					70,870	<u>70,870</u>
Comprehensive loss						<u>(1,703,200)</u>
Balance at December 31, 2008	1,395,163	14,987,056	44,262	(1,780,028)	110,163	13,361,453
Vesting of restricted common stock		20,000				20,000
Stock-based compensation, stock options			25,520			25,520
Sales of common stock	181,851	544,288				544,288
Net loss for the year ended December 31, 2009				(6,049,565)		(6,049,565)
Write off deferred tax related to unrealized gain/loss					48,066	48,066
Unrealized loss on available-for- sale securities					(16,857)	<u>(16,857)</u>
Comprehensive loss						<u>(6,018,356)</u>
Balance at December 31, 2009	<u>1,577,014</u>	<u>\$ 15,551,344</u>	<u>\$ 69,782</u>	<u>\$ (7,829,593)</u>	<u>\$ 141,372</u>	<u>\$ 7,932,905</u>

The accompanying notes are an integral part of these financial statements

**BUSINESS BANK
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008**

	<u>2009</u>	<u>2008</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (6,049,565)	\$ (1,774,070)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	308,805	254,215
Provision for loan losses	5,000,979	2,839,435
Writedown on other real estate owned	188,816	35,000
(Gain) loss on sale of investments	(20,960)	470,994
Gain on sale of loans	(451,840)	(281,296)
Loss on sale of other real estate owned	230,852	-
Deferred federal income tax expense (benefit)	508,166	(118,549)
Net discount amortization (accretion) on investment securities	35,424	(12,606)
Stock-based compensation	45,520	45,222
Proceeds from sales of loans held-for-sale	17,713,585	21,983,446
Originations of loans held-for-sale	(17,404,245)	(20,831,900)
(Increase) decrease in federal income tax refund receivable	597,867	(597,867)
(Increase) decrease in other assets	(5,059)	54,453
Increase (decrease) in other liabilities	154,728	(138,659)
Total adjustments	<u>6,902,638</u>	<u>3,701,888</u>
Net Cash Provided by Operating Activities	<u>853,073</u>	<u>1,927,818</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available-for-sale securities	(19,546,201)	(3,004,168)
Purchases of held-to-maturity securities	-	(250,000)
Proceeds from maturities of available-for-sale securities	1,000,000	-
Proceeds from maturities of held-to-maturity securities	250,000	1,250,000
Proceeds from sales of available-for-sale securities	4,032,304	540,168
Principal payments on available-for-sale securities	1,763,836	511,274
Purchase of FHLB stock	(64,300)	(930,000)
Net (increase) decrease in loans receivable	16,191,095	(16,252,845)
Cash proceeds from sales of other real estate owned	2,748,660	-
Purchases of furniture and equipment	(78,306)	(742,038)
Net Cash Provided (Used) by Investing Activities	<u>6,297,088</u>	<u>(18,877,609)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	4,263,548	2,937,785
Proceeds from FHLB borrowings	12,200,000	27,000,000
Payments on FHLB borrowings	(16,200,000)	(13,000,000)
Net increase (decrease) in short-term borrowings	(440,000)	440,000
Net proceeds from common stock issued	544,288	163,170
Net Cash Provided by Financing Activities	<u>367,836</u>	<u>17,540,955</u>
Net increase in cash and cash equivalents	7,517,997	591,164
Cash and cash equivalents at beginning of year	<u>2,686,904</u>	<u>2,095,740</u>
Cash and cash equivalents at end of year	<u>\$ 10,204,901</u>	<u>\$ 2,686,904</u>
SUPPLEMENTAL SCHEDULE:		
Cash paid for interest	\$ 3,175,965	\$ 3,857,678
Income taxes paid	-	317,385
Income taxes refunded	601,830	-
Other real estate acquired through foreclosure	8,557,727	469,545
Bank financed sales of other real estate	508,000	-

The accompanying notes are an integral part of these financial statements.

**BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008**

Note 1 Description of Business

Business Bank (the "Bank") is a commercial bank chartered in the State of Washington. The Bank began operations April 11, 2005 and has three locations as of December 31, 2009: Burlington, Bellingham, and Mt. Vernon, Washington. A fourth branch in Lynden, Washington was closed in October 2009. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals in and around Skagit and Whatcom counties. The Bank operates under a state bank charter and is subject to regulation by the State of Washington Department of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC).

Note 2 Going Concern

The financial statements have been prepared assuming that the Bank will continue as a going concern. The Bank has incurred significant losses during 2009 and 2008. On September 1, 2009, the Bank agreed to the issuance of an Order to Cease and Desist by the FDIC and Washington Department of Financial Institutions which is more fully disclosed in Note 14. Failure to comply with the provisions in the Order could result in additional regulatory sanctions causing concern about the future viability of the Bank. These events raise substantial doubt about the Bank's ability to continue as a going concern. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

The Bank has worked diligently to comply with all aspects of the Order. The liquidity position has been improved and within the Order's guidelines. The Bank has also hired a Special Credits officer with the experience to help deal with the troubled assets. The Bank is planning on raising more capital and efforts are underway to file the paperwork necessary with the FDIC after the adjustments from their last examination. This new capital would be used to recapitalize the Bank and enable the Bank to comply with the Order.

Note 3 Summary of Significant Accounting Policies

Financial Statement Presentation

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Estimates, continued

The Bank's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Cash and Cash Equivalents

Cash and due from banks consists of vault cash, cash items in the process of collection, and noninterest-bearing deposits with financial institutions. For purposes of the statement of cash flows, the Bank considers cash and cash equivalents to include cash, due from banks, investments with an original maturity of three months or less, and federal funds sold.

Restrictions on Cash and Due From Banks

Business Bank is required to maintain reserve funds in cash or on deposit with Pacific Coast Bankers' Bank. The required reserve at December 31, 2009 was \$10,000.

Investment Securities

The Bank accounts for investment securities according to authoritative guidance issued by the FASB. Under the provisions of the FASB authoritative guidance, debt securities that management has the ability and intent to hold to maturity are classified as held-to-maturity and carried at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Debt securities not classified as held-to-maturity are classified as available-for-sale. Securities available-for-sale are carried at fair value with unrealized gains and losses reported in other comprehensive income. Realized gains (losses) on securities available-for-sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax (benefit), in other comprehensive income. Gains and losses on sales of securities are determined on the specific-identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their amortized cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Federal Home Loan Bank and Pacific Coast Bankers' Bank Stock

The Bank's investment in Federal Home Loan Bank (FHLB) stock is a restricted investment carried at cost (\$100 per share par value), which reasonably approximates its fair value. As a member of the FHLB system, the Bank is required to maintain a minimum level of investment in FHLB stock based on specific percentages of its outstanding FHLB advances. The Bank may request redemption at par value of any stock in excess of the amount the Bank is required to hold. Stock redemptions are at the discretion of the FHLB.

The Bank owns stock in Pacific Coast Bankers' Bank (PCBB). The investment in PCBB stock is a restricted investment carried at cost (\$475 per share par value), which reasonably approximates its fair value. As a holder of PCBB stock, the Bank is allowed to borrow at a lower interest rate than a non-holder and to receive dividends.

Loans Held-for-Sale

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses are recognized through a valuation allowance by charges to income.

Mortgage loans held-for-sale are generally sold with the mortgage servicing rights released by the Bank. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

Loans

Loans that management has the intent and ability to hold for the foreseeable future are stated at the principal amount outstanding, net of allowance for loan losses and deferred fees. Interest on loans is calculated using the simple interest method based on the daily balance of principal amount outstanding and is credited to income when earned. Interest is accrued as earned unless management doubts the collectibility of interest or principal, at which time the loan is placed on nonaccrual status and accrued but unpaid interest is charged against income in that period. Any loan delinquent 90 days or more is placed on nonaccrual. Accrual of interest income is resumed when the borrower demonstrates the ability to make scheduled payments of both principal and interest.

Management considers loans impaired when it is probable the Bank will not be able to collect all amounts as scheduled under a loan agreement. Impaired loans are measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Changes in these values will be reflected in income and as adjustments to the allowance for possible loan losses.

The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, unless the loan is well secured and in the process of collection. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received, or payment is considered certain.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed to be sufficient to absorb potential losses in the portfolio. The allowance for specific loan losses is provided on loans, which are considered impaired when full collectibility may not be assured. The allowance is established by a charge against operations in the period the loss is identified. General loan loss reserves are established to provide for inherent risks in the portfolio. The reserves are based on management's continuing evaluation of the pertinent factors underlying the credit quality of the loan portfolio, including changes in the size and composition of the loan portfolio, actual loan loss experience, and current and anticipated economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. Additionally, loans are subject to examinations by state and federal regulators, who, based upon their judgment, may require the Bank to make additional provisions or adjustments to its allowance for loan losses. Past due status is determined based on contractual terms.

Loan Originations Fees

During 2009 and 2008, the Bank fully implemented authoritative guidance issued by the FASB, by properly deferring both loan fee income and loan origination costs. Deferred loan origination costs of \$70,287 and \$371,763 are included as a reduction in Salaries and Employee Benefits in 2009 and 2008, respectively. Loan fee income for 2009 and 2008 was reduced by \$98,933 and \$190,845, respectively, due to deferral of loan origination costs. Net deferred fees of \$104,445 and \$223,416 are included in total loans at December 31, 2009 and, 2008, respectively.

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.

Premises and Equipment

Property, equipment and leasehold improvements are recorded at cost, net of accumulated depreciation and amortization. Gains and losses on dispositions are reflected in operations. Expenditures for improvements and major renewals are capitalized, and ordinary maintenance, repairs, and small purchases are charged to operations as incurred.

Depreciation and Amortization

Property, equipment and leasehold improvements are depreciated or amortized over the estimated useful life of the related asset, three to thirty-nine years. The Bank uses the straight-line method of recognizing depreciation and amortization expenses. Leasehold improvements are amortized over lease terms on a straight-line basis.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Other Real Estate

Other real estate is foreclosed property held pending disposition and is initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. At foreclosure, if the fair value of the real estate acquired less estimated selling costs is less than the Bank's recorded investment in the related loan, a writedown is recognized through a charge to the allowance for loan losses. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent writedowns are recorded as a charge to income, if necessary, to reduce the carrying value of the property to its fair value less estimated selling costs. Sales of other real estate are accounted for according to authoritative guidance issued by the FASB.

Income Taxes

Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the tax and financial reporting of the allowance for loan losses, accumulated depreciation, organization costs, and conversion from accrual to cash basis.

The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at 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.

Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense (benefit) is the income tax payable (receivable) for the year and the change during the year in deferred tax assets and liabilities.

Advertising Costs

The Bank expenses advertising costs as they are incurred. Total advertising expense was \$49,180 and \$73,311 for the years ended December 31, 2009 and 2008, respectively.

Stock-Based Employee Compensation

The Bank has a stock-based compensation plan described more fully in Note 16. The Bank was required to adopt authoritative guidance issued by the FASB regarding stock compensation effective January 1, 2006. As permitted by this guidance, the Bank accounts for stock option awards using the calculated value method. Prior to 2006, the Bank used the minimum value method permitted by FASB Statement No. 123 (SFAS 123), to account for stock options granted to employees.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Stock-Based Employee Compensation, continued

The provisions of the new guidance are applicable to stock options awarded by the Bank and the Bank is required to recognize compensation expense for options granted in 2006 and thereafter. The Bank used the modified prospective application transition method in adopting this new FASB guidance. Under the modified prospective method, the Bank recognizes compensation expense for all share-based payments granted on or after January 1, 2006 based on the grant date fair value in accordance with FASB guidance. See Note 16 for information about the Bank's stock-based compensation plan and the assumptions used to calculate the fair value of share-based employee compensation.

The Bank's statements of operations include \$25,520 and \$25,222 of compensation expense related to stock-based compensation for options for the years ended December 31, 2009 and 2008, respectively. The financial statements also include \$20,000 in stock-based compensation for 2009 and 2008 related to a Restricted Stock Plan which is described in Note 16.

Financial Instruments

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

Fair Values of Financial Instruments

The FASB has issued authoritative guidance which requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. The FASB authoritative guidance excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating its fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values.

Investment securities: Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

FHLB stock and PCBB stock: These are restricted investments carried at cost which approximates fair value.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 3 Summary of Significant Accounting Policies, continued

Fair Values of Financial Instruments, continued

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans (for example, fixed rate commercial real estate and rental property mortgage loans and commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics.

Deposits: The fair values disclosed for demand deposits (for example, interest-bearing checking accounts and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

Long-Term Borrowings: The fair values of the Bank's long-term borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Short-Term Borrowings: The carrying amount of short-term borrowings approximates their fair values.

Accrued Interest: The carrying amount of accrued interest approximates its fair value.

Reclassifications

Certain reclassifications have been made to the 2008 financial statements to conform with current year presentations. Such reclassifications have had no effect upon previously reported net income.

New Accounting Standards

Effective July 1, 2009, the FASB established the Codification as the source of authoritative GAAP for companies to use in the preparation of financial statements. The guidance contained in the Codification supersedes all existing non-SEC accounting and reporting standards. The Bank adopted the Codification, as required, for the year ending December 31, 2009.

Subsequent Events

The Bank has evaluated subsequent events from December 31, 2009 through May 21, 2010, the date the financial statements were available to be issued. There were no subsequent events requiring disclosure or adjustment to these financial statements.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 4 Investment Securities

The amortized cost and fair values of investment securities at December 31, 2009 are as follows:

	December 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Government agency securities	\$ 507,002	\$ 2,028	\$ -	\$ 509,030
U.S. Government agency mortgage-backed securities	8,931,512	187,995	(86,989)	9,032,518
Obligations of state and Political subdivisions	6,454,023	73,124	(30,620)	6,496,527
SBA pools	1,889,951	-	(4,166)	1,885,785
Totals	<u>\$ 17,782,488</u>	<u>\$ 263,147</u>	<u>\$ (121,775)</u>	<u>\$ 17,923,860</u>

The balance sheet as of December 31, 2009 reflects the fair value of available-for-sale securities of \$17,923,860. A net unrealized gain of \$141,372 is in the available-for-sale investment securities balance. The unrealized gain is included in shareholders' equity.

The amortized cost and fair values of investment securities at December 31, 2008 are as follows:

	December 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities held-to-maturity:				
U.S. Government agency securities	\$ 250,000	\$ 1,614	\$ -	\$ 251,614
Total held-to-maturity	<u>250,000</u>	<u>1,614</u>	<u>-</u>	<u>251,614</u>
Securities available-for-sale:				
U.S. Government agency securities	521,250	-	(926)	520,324
U.S. Government agency mortgage-backed securities	4,149,241	156,650	-	4,305,891
Collateralized mortgage obligations	376,402	11,189	-	387,591
Total available-for-sale	<u>5,046,893</u>	<u>167,839</u>	<u>(926)</u>	<u>5,213,806</u>
Totals	<u>\$ 5,296,893</u>	<u>\$ 169,453</u>	<u>\$ (926)</u>	<u>\$ 5,465,420</u>

The balance sheet as of December 31, 2008 reflects the amortized cost of held-to-maturity securities of \$250,000 and the fair value of available-for-sale securities of \$5,213,806 for a total of \$5,463,806. A net unrealized gain of \$166,913 is in the available-for-sale investment securities balance. The unrealized gain, net of tax, is included in shareholders' equity.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 4 Investment Securities, continued

The amortized cost and fair values of available-for-sale securities by contractual maturity at December 31, 2009 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or pre-payment penalties. Mortgage-backed securities and SBA pools are shown separately since they are not due at a single maturity date.

	Available-for-Sale	
	Amortized Cost	Fair Value
Amounts maturing:		
After one year through five years	\$ 6,961,025	\$ 7,005,557
Mortgage-backed securities	8,931,512	9,032,518
SBA pools	1,889,951	1,885,785
Totals	\$17,782,488	\$17,923,860

During 2009, there were proceeds from sales of available-for-sale investment securities in the amount of \$4,032,304 which resulted in gross realized gains of \$30,127 and gross realized losses of \$9,167. During 2008, there were proceeds from sales of available-for-sale investment securities in the amount of \$540,168 which resulted in gross realized losses of \$470,994.

Securities with carrying amounts of \$9,541,549 and \$1,244,668 at December 31, 2009 and 2008, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

Information pertaining to securities with gross unrealized losses at December 31, 2009 and 2008, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
December 31, 2009:						
Federal agencies	\$ 6,203,718	\$ (91,155)	\$ -	\$ -	\$ 6,203,718	\$ (91,155)
Municipals	1,542,867	(30,620)	-	-	1,542,867	(30,620)
Totals	\$ 7,746,585	\$ (121,775)	\$ -	\$ -	\$ 7,746,585	\$ (121,775)
December 31, 2008:						
Federal agencies	\$ 520,324	\$ (926)	\$ -	\$ -	\$ 520,324	\$ (926)
Totals	\$ 520,324	\$ (926)	\$ -	\$ -	\$ 520,324	\$ (926)

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 4 Investment Securities, continued

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issue for a period of time sufficient to allow for any anticipated recovery in fair value.

Certain investment securities shown above currently have fair values less than amortized cost and therefore contain unrealized losses. At December 31, 2009, there are 16 investment securities with an unrealized loss of 1.55% from their amortized cost. 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 company or industry specific event. 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. As management has the ability to hold debt securities until maturity, or for the foreseeable future if classified as available-for-sale, no declines are deemed to be other-than-temporary.

Note 5 Loans Receivable and Allowance for Loan Losses

The composition of loans receivable at December 31 is as follows:

	<u>2009</u>	<u>2008</u>
Commercial	\$ 13,705,641	\$ 15,967,903
Real Estate	67,427,021	91,114,333
Agriculture	2,828,522	5,474,403
Consumer	524,979	743,532
Overdrafts	6,131	36,151
	<u>84,492,294</u>	<u>113,336,322</u>
Less allowance for loan losses	<u>(2,825,208)</u>	<u>(2,162,497)</u>
Loans, net	<u>\$ 81,667,086</u>	<u>\$ 111,173,825</u>

Transactions in the allowance for loan losses are summarized as follows:

	<u>2009</u>	<u>2008</u>
Balance at beginning of year	\$ 2,162,497	\$ 1,264,944
Provision charged to expense	5,000,979	2,839,435
Loans charged-off	(4,514,096)	(1,912,130)
Recoveries of loans previously charged-off	175,828	6,000
Reclassify off-balance sheet reserve	-	(35,752)
Balance at end of year	<u>\$ 2,825,208</u>	<u>\$ 2,162,497</u>

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 5 Loans Receivable and Allowance for Loan Losses, continued

At December 31, 2009 and 2008, total nonaccrual loans were \$7,356,403 and \$5,842,606, respectively. The recorded investment in impaired loans at December 31, 2009 and 2008 is as follows:

	<u>2009</u>	<u>2008</u>
Balance of impaired loans with no allocated allowance	\$ 4,529,066	\$ 4,348,366
Balance of impaired loans with an allocated allowance	11,594,443	4,257,276
Total recorded investment in impaired loans	<u>\$ 16,123,509</u>	<u>\$ 8,605,642</u>
Amount of the allowance allocated to impaired loans	<u>\$ 1,481,163</u>	<u>\$ 804,865</u>

The average recorded investment in impaired loans amounted to approximately \$12,365,000 and \$3,547,000 for the years ended December 31, 2009 and 2008, respectively. No interest income was recognized on these loans during 2009 and 2008. The Bank has no commitments to loan additional funds to borrowers whose loans are impaired. Loans past due 90 days or more and still accruing at December 31, 2009 totaled \$452,449. There were no loans past due 90 days or more and still accruing interest at December 31, 2008.

Note 6 Premises and Equipment

The components of premises and equipment at December 31 are as follows:

	<u>2009</u>	<u>2008</u>
Land	\$ 604,771	\$ 604,771
Building	1,732,318	1,732,318
Leasehold improvements	567,930	420,890
Equipment, furniture, and fixtures	993,060	902,218
Construction in process	-	167,499
Total cost	<u>3,898,079</u>	<u>3,827,696</u>
Less accumulated depreciation	<u>(908,471)</u>	<u>(607,590)</u>
Total	<u>\$ 2,989,608</u>	<u>\$ 3,220,106</u>

Depreciation and amortization charged against operations for the years ended December 31, 2009 and 2008 was \$308,805 and \$254,215, respectively.

The Bank leases its branch facilities in Bellingham, Lynden and South Mount Vernon under operating leases with initial lease terms of five years. These leases include renewal options and provide for rate adjustment based on changes in various economic indicators. Gross rental expense was \$167,946 for 2009 and \$120,951 for 2008 which is included in occupancy and equipment expense.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 6 Premises and Equipment, continued

The Lynden branch was closed on October 15, 2009. Management is negotiating with the lessor and other parties to sublease this facility since the lease term continues until March 2013.

Minimum gross rental commitments under non-cancellable leases having an original or remaining term of more than one year are as follows at December 31, 2009:

2010	\$ 164,775
2011	150,470
2012	135,760
2013	77,391
2014	-
Total	<u>\$ 528,396</u>

Note 7 Deposits

The composition of deposits at December 31 is as follows:

	<u>2009</u>	<u>2008</u>
Noninterest checking	\$ 8,603,341	\$ 8,962,135
Interest-bearing checking and money market	16,295,845	18,834,492
Savings deposits	331,510	403,153
Time deposits, less than \$100,000	61,648,420	44,762,899
Time deposits, \$100,000 or more	<u>6,019,816</u>	<u>15,672,704</u>
Total deposits	<u>\$ 92,898,932</u>	<u>\$ 88,635,383</u>

Included in time deposits are brokered deposits of \$6,714,872 at December 31, 2009. The scheduled maturities of time deposits at December 31, 2009 are as follows:

2010	\$ 57,717,687
2011	8,991,694
2012	256,733
2013	202,646
2014	<u>499,476</u>
Total	<u>\$ 67,668,236</u>

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 8 Federal Income Taxes

Income taxes are comprised of the following for the years ended December 31:

	<u>2009</u>	<u>2008</u>
Provision for income tax:		
Current (benefit)	\$ -	\$ (386,214)
Deferred (benefit)	<u>508,166</u>	<u>(118,549)</u>
Total income tax provision (benefit)	<u>\$ 508,166</u>	<u>\$ (504,763)</u>

The following reconciliation is between the statutory and the effective federal income tax rate for the years ended December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Federal income tax benefit at statutory rate	\$(1,388,689)	\$ (774,803)
Increase (decrease) resulting from:		
Disallowed expenses	11,230	3,112
Tax-exempt income	(54,005)	-
Stock-based compensation	11,403	8,575
Other	1,644	(1,867)
Valuation allowance	<u>1,926,583</u>	<u>260,220</u>
Total income tax (benefit)	<u>\$ 508,166</u>	<u>\$ (504,763)</u>

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 8 Federal Income Taxes, continued

The tax effects of temporary differences that give rise to significant portions of deferred tax assets and liabilities are:

	2009	2008
Deferred tax assets:		
Organizational expenditures	\$ 55,576	\$ 83,539
Net operating loss carryover	1,487,741	260,220
Allowance for possible loan losses in excess of tax reserves	667,250	594,600
Basis difference on other real estate owned	54,120	11,900
Off-balance sheet liability	4,830	12,156
Accrual to cash adjustment	30,120	-
Other	3,680	2,096
Total deferred tax asset	2,303,317	964,511
Deferred tax liabilities:		
Unrealized gain on available-for-sale securities	-	56,750
Accrual to cash adjustment	-	46,781
Premises and equipment	102,583	113,612
Other	13,931	31,769
Total deferred tax liability	116,514	248,912
Less Valuation Allowance	(2,186,803)	(260,220)
Net deferred tax asset	\$ -	\$ 455,379

The Bank incurred a net operating loss of approximately \$6,050,000 for financial reporting purposes and a taxable loss of \$3,696,000 for the year ended December 31, 2009. All taxes previously paid in prior years have been recovered; therefore, the Bank will have a net operating loss carryover for tax purposes of approximately \$4,376,000. The tax net operating loss may be carried forward a period of twenty years to offset future taxable income.

The Bank's 2008 net operating loss was carried back to obtain refunds of \$365,482, which were received during 2009. Realization of the future tax benefits of the net operating loss is dependent upon the Bank's ability to generate future taxable income. Due to the uncertainty of future earnings, management is unable to predict whether the deferred tax asset will be realized and therefore has recorded a valuation allowance of \$2,186,803 as of December 31, 2009. The net deferred tax asset of \$508,166 was expensed at December 31, 2009.

**BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008**

Note 9 Related Party Transactions

During 2009 and 2008, Business Bank had transactions made in the ordinary course of business with certain of its officers, directors and principal shareholders. All loans included in such transactions were made on substantially the same terms, including interest rate and collateral, as those prevailing at the time for comparable transactions with other persons, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

A summary of these transactions follows:

	<u>Balance Beginning of Year</u>	<u>Additions</u>	<u>Amounts Collected</u>	<u>Balance End of Year</u>
For the year ended December 31, 2009	\$ 3,714,892	\$ 787,214	\$ (1,545,135)	\$ 2,956,971
For the year ended December 31, 2008	\$ 3,720,127	\$ 1,441,818	\$ (1,447,053)	\$ 3,714,892

The Bank also had unfunded commitments to executive officers, directors and principal shareholders of approximately \$609,000 at December 31, 2009.

At December 31, 2009 and 2008, the Bank held related-party deposits of approximately \$2,417,000 and \$2,762,000, respectively, which includes deposits held for directors, executive officers, principal shareholders, and related business entities.

Note 10 Federal Home Loan Bank Borrowings

Business Bank is a member of the Federal Home Loan Bank (FHLB) of Seattle, which entitles it to certain benefits including a variety of borrowing options. The FHLB borrowings at December 31, 2009 and 2008 consist of a warehouse securities credit line (securities line), which also allows for advances with interest rates fixed at the time of borrowing, a warehouse cash management advance line (CMA line), which allows daily advances at variable interest rates, and a putable advance option, in which the borrower is "paid" for selling the options embedded in the advance, which enables the Bank to borrow at rates below those for regular fixed-rate advances. It also has a "Bermudin" option, which means that the option is exercisable at June 1, 2008 and every quarter thereafter. Credit capacity is primarily determined by the value of assets collateralized at the FHLB, funds on deposit at the FHLB, and stock owned by the Bank. Credit is limited to 25% of the Bank's total assets. Total collateral pledged to the FHLB as of December 31, 2009 and 2008 consisted of loans and investment securities of \$29,271,226 and \$28,592,000, respectively. The Bank has available borrowing capacity of an additional \$341,000 at December 31, 2009. In September 2009, FHLB charged a prepayment penalty of \$42,000 when the Bank repaid a \$4,000,000 advance prior to its scheduled maturity.

**BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008**

Note 10 Federal Home Loan Bank Borrowings, continued

Advances on these lines at December 31, 2009 were as follows:

Securities line:	
Putable advance, interest rate 3.28%	\$ 3,000,000
Putable advance, interest rate 4.61%	2,000,000
Putable advance, interest rate 2.38%	4,000,000
Fixed interest rate of 2.26%	<u>10,000,000</u>
Total	<u>\$ 19,000,000</u>

At December 31, 2009, scheduled maturities of the advances are as follows:

<u>Years Ending December 31,</u>	<u>Amount</u>
2010	\$ -
2011	10,000,000
2012	-
2013	4,000,000
2014	-
Thereafter	<u>5,000,000</u>
Total	<u>\$ 19,000,000</u>

Note 11 Lines of Credit

At December 31, 2009, the Bank had available a collateralized line of credit with the Federal Reserve Bank of San Francisco (FRB). Loans with outstanding balance of \$11,664,354 were pledged to the FRB at December 31, 2009 for available borrowings of \$4,580,629. There were no outstanding borrowings on this line as of December 31, 2009.

At December 31, 2008, the Bank had credit available through Pacific Coast Banker's Bank under a \$5 million unsecured federal funds line of credit. Pricing is based upon Pacific Coast Banker's Bank's rates at the time of the borrowing. This facility is not a committed facility and can be cancelled by either party. There were outstanding advances of \$440,000 on this line at December 31, 2008. This line of credit was not available in 2009.

Note 12 Commitments and Contingent Liabilities

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet.

**BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008**

Note 12 Commitments and Contingent Liabilities, continued

Commitments to extend credit and possible credit risk were as follows:

	<u>2009</u>	<u>2008</u>
Commitments to extend credit	\$ 2,924,000	\$ 9,569,000
Commercial letters of credit	2,603,000	3,327,000
Standby letters of credit	5,000	171,000

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

The Bank has not been required to perform on any financial guarantees nor incurred any losses on its commitments during 2009 or 2008.

The Bank is subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Bank.

The Bank participates in the Washington State Public Depository program. Prior to February 2009, financial institutions that participated in this program were part of the collateral pool that was established to protect public deposits. As a participant, the Bank was responsible for its pro rata share of restoring the public deposit funds for any uninsured public deposits held in a failed financial institution.

In February 2009, new standards were adopted which require institutions to collateralize uninsured public deposits at 100 percent. At December 31, 2009, the Bank had pledged \$3,300,000 to secure public deposits. Refer to Note 4 – Investment Securities.

Note 13 Concentrations of Credit Risk

The Bank maintains its cash accounts with several correspondent banks. Generally, accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to \$250,000 per bank. There were no uninsured deposits at December 31, 2009. Furthermore, federal funds sold are essentially uncollateralized loans to other financial institutions. Management regularly evaluates the credit risk associated with the counterparties to these transactions and believes that the Bank is not exposed to any significant credit risks on cash and cash equivalents.

The Bank grants agribusiness, commercial, consumer, and real estate loans to customers within Skagit and Whatcom Counties, Washington and the surrounding areas. Concentrations of credit by loan type are set forth in Note 5.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 14 Regulatory Matters

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

On September 1, 2009, the Bank entered into an Order to Cease and Desist (Consent Agreement) with the FDIC and Washington Department of Financial Institutions. The Agreement requires the Bank to take certain actions to strengthen board oversight, strengthen credit risk management, reduce loan concentrations, improve asset quality, adopt and implement a comprehensive policy for determining the adequacy of the allowance for loan losses, achieve and maintain primary liquidity ratio of at least 15%, and maintain specified capital levels. The Agreement requires the Bank to have and thereafter maintain Tier 1 Capital to Total Assets Ratio to equal or exceed 10% and Total Risk-Based Capital Ratio to equal or exceed 13%.

The capital amounts and classification are also subject to qualitative judgments by 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, and of Tier I capital to average assets. The Bank's actual and required capital amounts and ratios are as follows:

	<u>Actual</u>		<u>Minimum Required for Capital Adequacy Purposes</u>		<u>Required to be Adequately Capitalized under the Prompt Corrective Action Capital Directive</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
As of December 31, 2009:						
Tier 1 Capital (to Adjusted Total Average Assets)	\$ 7,792	6.18%	\$ 5,047	4.00%	\$ 12,618	10.00%
Tier 1 Capital (to Risk- weighted Assets)	\$ 7,792	8.50%	\$ 3,724	4.00%	\$ 5,500	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	\$ 8,976	9.79%	\$ 7,449	8.00%	\$ 11,915	13.00%
As of December 31, 2008 : (Reflects PCA requirements prior to Capital Directive in 2009)						
Tier 1 Capital (to Adjusted Total Average Assets)	\$ 13,251	10.47%	\$ 5,065	4.00%	\$ 6,331	5.00%
Tier 1 Capital (to Risk- weighted Assets)	\$ 13,251	11.64%	\$ 4,554	4.00%	\$ 6,832	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	\$ 14,683	12.90%	\$ 9,109	8.00%	\$ 11,386	10.00%

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 15 Equity Transactions

The Bank had a secondary stock offering during 2009 and 2008. During 2009, an additional 181,851 shares of stock were sold for total proceeds of \$544,288. During 2008, an additional 11,655 shares of stock were sold for total proceeds of \$163,170.

Note 16 Stock-Based Compensation

Stock Option Plan

In June 2005, the Board of Directors approved the adoption for the 2005 Stock Option Plan (“2005 Plan”), whereby, the Bank may grant awards to employees and directors of shares of common stock such as Incentive and Non-Qualified Stock Options as determined by the Administrator at the time of grant. The total number of options reserved for grant under the Plan was increased from 165,000 to 250,000 options in May 2008. At December 31, 2009, 115,250 shares of common stock were reserved for future grants. The Plan does not stipulate any terms or conditions for the awards to be granted. The options granted in 2009 and 2008 were granted at a price not less than market value at the date of the grant, vest over five years, and have a term of ten years, and are all Incentive Stock Options.

The Bank uses the Black-Scholes option pricing model to estimate the fair value of each option grant on the date of grant or modification. The Bank amortizes the estimated fair value to stock compensation expense using the straight-line method over the vesting period of the option. Following, is a description of the significant assumptions used in the option-pricing model:

Expected Term – The expected term is the period of time that granted options are expected to be outstanding. The Bank estimates the expected term based on historical patterns of option exercises, as well as potential future events that may increase liquidity. These factors are believed to reflect future exercise behavior.

Expected Volatility – Because the Bank’s stock is not traded in an active market, the Bank calculates volatility by using the historical stock prices of similar banks going back over the estimated life of the option and averaging the volatilities of these banks.

Risk-Free Interest Rate – The Bank bases the risk-free interest rate used in the Black-Scholes option valuation model on the market yield in effect at the time of the option grant provided from the Federal Reserve Board’s Statistical Releases and Historical publications from the Treasury constant maturities rates for the equivalent remaining terms.

Dividends – The Bank does not have plans to pay cash dividends in the future. Therefore, the Bank uses an expected dividend yield of zero in the Black-Scholes option valuation model.

The following assumptions were used to estimate the value of options granted for the years ended December 31, 2009 and 2008:

	<u>2009</u>	<u>2008</u>
Average expected term	7.0 years	7.0 years
Expected stock price volatility	20.00%	20.00%
Risk free interest rate	2.36%	3.47%
Expected dividends	Zero	Zero

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 16 Stock-Based Compensation, continued

Option activity under the Plan for the years ended December 31, 2009 and 2008 is summarized as follows:

<u>Options</u>	<u>Shares</u>	<u>Weighted- Average Exercise Price</u>	<u>Weighted- Average Remaining Contractual Term</u>
Outstanding at January 1, 2008	142,500	\$ 10.75	
Granted	5,750	13.57	
Exercised	-	-	
Forfeited or expired	(6,000)	10.67	
Outstanding at December 31, 2008	<u>142,250</u>	<u>10.85</u>	<u>6.94</u>
Vested or expected to vest at December 31, 2008	<u>142,250</u>	<u>10.85</u>	<u>6.94</u>
Exercisable at December 31, 2008	<u>74,750</u>	<u>10.29</u>	<u>6.57</u>
Outstanding at January 1, 2009	142,250	\$ 10.85	
Granted	2,000	5.88	
Exercised	-	-	
Forfeited or expired	(12,500)	13.16	
Outstanding at December 31, 2009	<u>131,750</u>	<u>10.55</u>	<u>5.47</u>
Vested or expected to vest at December 31, 2009	<u>131,750</u>	<u>10.55</u>	<u>5.47</u>
Exercisable at December 31, 2009	<u>95,650</u>	<u>10.32</u>	<u>5.61</u>

The weighted-average grant-date fair value of options granted during the years ended December 31, 2009 and 2008, were \$1.63 and \$4.23, respectively. There were no options exercised during the years ended December 31, 2009 or 2008.

A summary of the status of the Bank's nonvested shares as of December 31, 2008, and changes during the year ended December 31, 2008, is presented below:

<u>Nonvested Shares</u>	<u>Shares</u>	<u>Weighted- Average Grant-Date Fair Value</u>
Nonvested at January 1, 2008	98,200	\$ 4.60
Granted	5,750	4.23
Vested	(31,450)	4.58
Forfeited	(5,000)	4.43
Nonvested at December 31, 2008	<u>67,500</u>	<u>4.54</u>

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 16 Stock-Based Compensation, continued

A summary of the status of the Bank's nonvested shares as of December 31, 2009, and changes during the year ended December 31, 2009, is presented below:

<u>Nonvested Shares</u>	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested at January 1, 2009	67,500	\$ 4.54
Granted	2,000	1.63
Vested	(25,450)	4.65
Forfeited	<u>(7,950)</u>	<u>1.95</u>
Nonvested at December 31, 2009	<u>36,100</u>	<u>\$ 2.08</u>

As of December 31, 2009, there was \$63,468 of total unrecognized compensation cost related to non-vested stock options granted under the Plan. Total unrecognized compensation costs will be adjusted for future changes in estimated forfeitures. The Bank expects to recognize that cost over a period of approximately 4.25 years.

The following table summarizes information concerning currently outstanding and exercisable options:

<u>Exercise Prices</u>	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>	<u>Number Exercisable</u>
\$ 5.88	2,000	9.17	-
10.00	104,000	5.39	84,950
10.50	2,000	6.47	1,000
11.35	5,000	6.75	3,000
14.00	14,750	7.64	5,900
13.50	<u>4,000</u>	8.45	<u>800</u>
Total	<u>131,750</u>	7.31	<u>95,650</u>

Restricted Stock

The Bank grants employees restricted stock with a graded vesting period over five years. The Bank provided for 10,000 shares of restricted common stock to an employee in April 2005. There were no grants of restricted common stock during 2009 or 2008. At December 31, 2009, 9,333 shares of restricted common stock were vested. The Bank's statements of operations include \$20,000 of compensation expense related to restricted stock-based compensation for the years ended December 31, 2009 and 2008. As of December 31, 2009, the remaining amount of unrecognized compensation for restricted common stock is \$6,666, which will be recognized over a period of .25 years.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 17 Employee Benefit Plan

The Bank has a 401(k) profit sharing plan (the “Plan”) covering substantially all of its employees. Employees are eligible to participate in the Plan if they are 21 years of age and have completed three months of service. Eligible employees may contribute through payroll deductions and are 100% vested at all times in their deferral contributions account. The Bank is allowed to make annual matching contributions and/or employer “non-elective” contributions at its discretion. Participants are 100% vested in employer contributions after five years of service. Total 401(k) expense was \$3,010 and \$36,694 for the years ended December 31, 2009 and 2008, respectively.

Note 18 Fair Values of Financial Instruments

The estimated fair values of the Bank’s financial instruments are as follows (in thousands):

	2009		2008	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	\$ 1,517	\$ 1,517	\$ 2,598	\$ 2,598
Interest-bearing deposits with financial institutions	1,677	1,677	89	89
Federal funds sold	7,010	7,010	-	-
Investment securities	17,924	17,924	5,464	5,464
Federal Home Loan Bank stock	1,074	1,074	1,010	1,010
Pacific Coast Bankers’ Bank stock	190	190	190	190
Loans held-for-sale	208	208	66	66
Loans, net	81,667	82,792	111,174	111,294
Interest receivable	378	378	415	415
Financial liabilities:				
Deposits	92,899	92,951	88,635	88,200
FHLB borrowings	19,000	19,857	23,000	23,844
Short-term borrowings	-	-	440	440
Interest payable	255	255	224	224

The carrying amounts in the preceding table are included in the balance sheet under the applicable captions.

Note 19 Fair Value Measurements

Effective January 1, 2008, the Bank adopted new authoritative guidance issued by the FASB regarding fair value measurements for financial assets and financial liabilities. In accordance with this guidance, the Bank delayed the application for fair value measurements of nonfinancial assets and nonfinancial liabilities until January 1, 2009. The new authoritative guidance defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 19 Fair Value Measurements, continued

The authoritative guidance issued by the FASB defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

The authoritative guidance issued by the FASB requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, the authoritative guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- *Level 2 Inputs* – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.
- *Level 3 Inputs* – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Bank's financial assets and financial liabilities carried at fair value effective January 1, 2008.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 19 Fair Value Measurements, continued

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Bank's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Bank's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Bank's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Securities Available-for-Sale – U.S. Treasury securities are reported at fair value utilizing Level 1 inputs. Other securities classified as available-for-sale are reported at fair value utilizing Level 2 inputs. For these securities, the Bank obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

Impaired Loans – Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria.

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 and 2008, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	<u>Level 1 Inputs</u>	<u>Level 2 Inputs</u>	<u>Level 3 Inputs</u>	<u>Total Fair Value</u>
December 31, 2009:				
Available-For-Sale				
U.S. Government agency securities	\$ -	\$ 509,030	\$ -	\$ 509,030
U.S. Government agency mortgage-backed securities	-	9,032,518	-	9,032,518
Obligations of state and Political subdivisions	-	6,496,527	-	6,496,527
SBA pools	-	1,885,785	-	1,885,785
Totals	<u>\$ -</u>	<u>\$17,923,860</u>	<u>\$ -</u>	<u>\$17,923,860</u>
December 31, 2008:				
Available-For-Sale				
U.S. Government agency securities	\$ -	\$ 520,324	\$ -	\$ 520,324
U.S. Government agency mortgage-backed securities	-	4,305,891	-	4,305,891
Collateralized mortgage obligations	-	387,591	-	387,591
Totals	<u>\$ -</u>	<u>\$ 5,213,806</u>	<u>\$ -</u>	<u>\$ 5,213,806</u>

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Note 19 Fair Value Measurements, continued

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). During the years ended December 31, 2009 and 2008, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for possible loan losses based upon the fair value of the underlying collateral. During 2009 and 2008, impaired loans with a carrying value of \$16,123,509 and \$8,605,642, respectively were reduced by specific valuation allowance allocations totaling \$1,481,163 and \$804,865, respectively to a total reported fair value of \$14,642,346 and \$7,800,777, respectively, based on collateral valuations utilizing Level 3 valuation inputs.

Certain non-financial assets and non-financial liabilities measured at fair value on a recurring basis include reporting units measured at fair value in the first step of a goodwill impairment test. Certain non-financial assets measured at fair value on a non-recurring basis include non-financial assets and non-financial liabilities measured at fair value in the second step of a goodwill impairment test, as well as intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment. As stated above, the new authoritative guidance issued by the FASB became effective for these fair value measurements beginning January 1, 2009.