BUSINESS BANK
BURLINGTON, WASHINGTON

AUDITED FINANCIAL STATEMENTS

DECEMBER 31, 2010 AND 2009

June 15, 2011

Dear Shareholders,

2010 was a very challenging year for Business Bank. Facing potential failure, the Board of Directors made several difficult decisions early in 2010 to get the Bank back on the road to success. Of particular note was the decision to hire a new President/CEO and a new Executive Vice President/Chief Credit Officer. Working with this new senior management team, and with the strong support of each and every employee and the Shareholders, the Board focused on:

- Determining the depth of the Bank's loan problems.
- Charting a course to correct these loan problems.
- Restructuring the Banks operations.
- Raising Capital.

Accomplishments in these areas pulled the Bank back from the brink of failure by the end of 2010.

2011 thus far has seen a continuing focus on these areas. This strategy has led to even more successes. As of the date of this letter, the Bank has:

- Identified its loan problems.
- Activated and implemented a plan to correct these loan problems.
- Made significant progress in restructuring the Bank's operations.
- Raised sufficient Capital to bring the Bank's status back to Well Capitalized.

Our goals for 2011 are to complete these areas of focus, begin the process of moving out from under the Regulatory Consent Order, and bring the Bank back to profitability.

The enclosed Audited Financial Statements for 2009 and 2010 show total assets of $120,331,179 and $88,576.670 respectively. This decrease in total assets reflects the above mentioned restructuring which began in 2010. Losses for 2009 and 2010 were $6,049,565 and $5,079,636 respectively. Losses for the first quarter of 2011 were $515,636 (unaudited). Losses for the full year of 2011 are projected to be significantly less than prior years with profitability reached on a monthly basis by December of 2011. We expect 2012 to be a profitable year. In summation, although the Bank has struggled over the last two years, and is still facing some challenges, it is definitely been put back on track to future success.

Raising Capital continues to be an important part of our future plans. We are in process of opening a private offering to accredited investors, selling shares at $1.60 per share. We have raised additional Capital since the end of the first quarter, bringing our Tier I Capital ratio over 7.5% as of the end of May, 2011, and expect to raise further Capital over the next several months. As a shareholder, we ask for your continued support in this area. Referral of interested parties or investors to us, or any assistance you can provide, will be of tremendous help as we strive to strengthen your Bank.

Lastly, Business Bank has made a substantial recovery over the last several months. We are now actively pursuing new customers, growing deposits and making new loans – moving the Bank towards a successful future. We plan to have our Annual Shareholders' Meeting in the fall, as we did last year, and will have updated information for you at that time. In the meantime, please let us know if you have any questions or comments we can answer. We appreciate the wonderful support we have experienced from our Shareholders, and want to make sure you are well informed as we move the Bank forward.

Thank you.

Michal D. Cann	Don Gordon
President/CEO	Chairman of the Board

C O N T E N T S

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
of Business Bank
Burlington, Washington

We have audited the accompanying balance sheets of Business Bank as of December 31, 2010 and 2009, 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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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, 2010 and 2009, 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.

Stovall, Grandey & Allen, LLP

STOVALL, GRANDEY & ALLEN, L.L.P.
Fort Worth, Texas
April 22, 2011

BUSINESS BANK
BALANCE SHEETS
DECEMBER 31, 2010 AND 2009

	2010	2009
ASSETS		
Cash and due from banks	$ 1,064,974	$ 1,517,381
Interest-bearing deposits with financial institutions	10,207,438	8,687,520
Cash and cash equivalents	11,272,412	10,204,901
Investment securities - Note 4	8,939,794	17,923,860
Federal Home Loan Bank stock, at cost - Note 3	1,106,500	1,074,300
Pacific Coast Bankers' Bank stock, at cost - Note 3	190,000	190,000
Loans held-for-sale	-	208,000
Loans receivable, net of allowance for loan losses and deferred loan fees - Note 5	59,709,372	81,667,086
Other real estate owned	4,291,658	5,554,348
Premises and equipment, net - Note 6	2,562,806	2,989,608
Accrued interest receivable	225,126	377,774
Other assets	279,002	141,302
Total Assets	$ 88,576,670	$120,331,179
LIABILITIES		
Deposits - Note 7	$ 73,762,246	$ 92,898,932
Federal Home Loan Bank borrowings - Note 10	9,000,000	19,000,000
Accrued interest payable	107,092	254,866
Other liabilities	252,117	244,476
Total Liabilities	83,121,455	112,398,274
Commitments and contingencies - Notes 6, 10, 11, 12 and 13		
SHAREHOLDERS' EQUITY - Notes 14, 15 and 16		
Common stock, no par value; authorized: 10,000,000 and 5,000,000 shares at December 31, 2010 and 2009, respectively; Issued and outstanding: 3,279,609 and 1,577,014 shares at December 31, 2010 and 2009, respectively	18,308,449	15,551,344
Additional paid-in capital	92,600	69,782
Retained deficit	(12,909,229)	(7,829,593)
Accumulated other comprehensive income (loss)	(36,605)	141,372
Total Shareholders' Equity	5,455,215	7,932,905
Total Liabilities and Shareholders' Equity	$ 88,576,670	$120,331,179

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

BUSINESS BANK
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
Interest income		
Interest and fees on loans	$ 4,176,638	$ 6,212,105
Interest on investment securities	390,574	725,007
Interest on interest-bearing deposits with financial institutions	17,522	11,806
Total interest income	4,584,734	6,948,918
Interest expense		
On deposits	1,302,880	2,577,170
On borrowed funds	382,953	629,618
Total interest expense	1,685,833	3,206,788
Net interest income	2,898,901	3,742,130
Provision for loan losses - Note 5	2,893,797	5,000,979
Net interest income (expense) after provision for loan losses	5,104	(1,258,849)
Non-interest income		
Service charges on deposit accounts	119,042	122,232
Net gain on sale of investments	352,473	20,960
Net gain (loss) on sales of loans	(1,048)	451,840
Net gain (loss) on sales of fixed assets	(180,200)	465
Net loss on sales of other real estate owned	(136,654)	(230,852)
Other	25,410	14,158
Total non-interest income	179,023	378,803
Non-interest expense		
Salaries and employee benefits	1,766,167	2,131,075
Occupancy and equipment	628,212	623,382
Data processing fees	186,030	177,225
Professional fees	97,676	162,181
Prepayment penalties	123,393	41,766
FDIC assessment	319,074	366,735
OREO expense and writedowns	1,216,241	480,674
Unreimbursed loan expense	270,628	241,274
Directors and officers insurance	230,730	7,698
Other expense	425,612	429,343
Total non-interest expense	5,263,763	4,661,353
Loss before federal income tax expense	(5,079,636)	(5,541,399)
Federal income tax expense - Note 8	-	508,166
Net Loss	$ (5,079,636)	$ (6,049,565)

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, 2010 AND 2009

	Shares of Common Stock	Common Stock	Additional Paid-in Capital	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance at January 1, 2009	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)	(16,857)
Comprehensive loss						(6,018,356)
Balance at December 31, 2009	1,577,014	15,551,344	69,782	(7,829,593)	141,372	7,932,905
Vesting of restricted common stock		6,666				6,666
Stock-based compensation, stock options			22,818			22,818
Sales of common stock	1,702,595	2,750,439				2,750,439
Net loss for the year ended December 31, 2010				(5,079,636)		(5,079,636)
Unrealized loss on available-for-sale securities					(177,977)	(177,977)
Comprehensive loss						(5,257,613)
Balance at December 31, 2010	3,279,609	$ 18,308,449	$ 92,600	$ (12,909,229)	$ (36,605)	$ 5,455,215

The accompanying notes are an integral part of these financial statements

BUSINESS BANK
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (5,079,636)	$ (6,049,565)
Adjustments to reconcile net loss to net		
cash provided (used) by operating activities:		
Depreciation and amortization	292,305	308,805
Provision for loan losses	2,893,797	5,000,979
Writedown on other real estate owned	823,037	188,816
Net gain on sale of investments	(352,473)	(20,960)
(Gain) loss on sales of loans	1,048	(451,840)
(Gain) loss on sales of fixed assets	180,200	(465)
Net loss on sales of other real estate owned	136,654	230,852
Deferred federal income tax expense	-	508,166
Net amortization on investment securities	60,039	35,424
Stock-based compensation	29,484	45,520
Proceeds from sales of loans held-for-sale	206,952	17,713,585
Originations of loans held-for-sale	-	(17,404,245)
Decrease in federal income tax refund receivable	-	597,867
(Increase) decrease in other assets	60,598	(4,594)
Increase (decrease) in other liabilities	(140,134)	154,728
Total adjustments	4,191,507	6,902,638
Net Cash Provided (Used) by Operating Activities	(888,129)	853,073
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available-for-sale securities	(8,432,733)	(19,546,201)
Proceeds from maturities of available-for-sale securities	500,000	1,000,000
Proceeds from maturities of held-to-maturity securities	-	250,000
Proceeds from sales of available-for-sale securities	15,259,208	4,032,304
Principal payments on available-for-sale securities	1,728,039	1,763,836
Purchases of FHLB stock	(32,200)	(64,300)
Net decrease in loans receivable	14,481,802	16,191,095
Cash proceeds from sales of other real estate owned	4,885,157	2,748,660
Purchases of furniture and equipment	(47,386)	(78,306)
Net Cash Provided by Investing Activities	28,341,887	6,297,088
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	(19,136,686)	4,263,548
Proceeds from FHLB borrowings	3,605,000	12,200,000
Payments on FHLB borrowings	(13,605,000)	(16,200,000)
Net decrease in short-term borrowings	-	(440,000)
Net proceeds from common stock issued	2,750,439	544,288
Net Cash Provided (Used) by Financing Activities	(26,386,247)	367,836
Net increase in cash and cash equivalents	1,067,511	7,517,997
Cash and cash equivalents at beginning of year	10,204,901	2,686,904
Cash and cash equivalents at end of year	$ 11,272,412	$ 10,204,901
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	$ 1,833,607	$ 3,175,965
Income taxes refunded	-	601,830
Other real estate acquired through foreclosure	5,205,566	8,557,727
Bank financed sales of other real estate	232,750	508,000

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

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

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 had three locations as of December 31, 2010: 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 Retained Deficit and Management Plans

The Bank experienced net operating losses during the last three years which attributed to a retained deficit balance of $12,909,229 at December 31, 2010. In addition, the Bank is operating under the provisions of a Cease and Desist Order (Order) issued by the FDIC and Washington Department of Financial Institutions in September 2009. Under new management in 2010, the Board of Directors has approved a revised Capital Restoration Plan which outlines specific steps and timeframes to achieve and maintain specific capital levels. The Plan calls for a return to profitability beginning the fourth quarter of 2011. Additional capital of $2.75 million was raised during 2010 and additional amounts were raised subsequent to year end (refer to Note 20 – Subsequent Events). Management is working diligently to comply with all aspects of the Order. A special credits officer with experience dealing with troubled assets was hired in 2010. The goal for 2011 is to reduce the level of foreclosed and nonperforming assets and replace those assets with earning assets. Management and the Board continue to pursue additional sources of capital.

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.

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, 2010 was $250,000.

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 writedowns of the individual securities to their fair value. The related writedowns 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.

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 loan 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.

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 Origination Fees

The Bank has adopted authoritative guidance issued by the FASB regarding deferral of loan fee income and loan origination costs. Deferred loan origination costs of $184,027 and $70,287 are included as a reduction in Salaries and Employee Benefits in 2010 and 2009, respectively. Loan fee income for 2010 and 2009 was reduced by $177,507 and $98,933, respectively, due to deferral of loan origination costs. Net deferred fees of $12,063 and $104,445 are included in total loans at December 31, 2010 and 2009, 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, which ranges from 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.

Note 3 Summary of Significant Accounting Policies, continued

Other Real Estate Owned

Other real estate owned 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.

In accordance with authoritative guidance issued by the FASB, the Bank performed an evaluation to determine if there were any uncertain tax positions that would have an impact on the financial statements. No uncertain tax positions were identified. The December 31, 2007 through December 31, 2010 tax years remain subject to examination by the Internal Revenue Service. The Bank does not believe that any reasonably possible changes will occur within the next 12 months which will have a material impact on the financial statements. The Bank records incurred penalties and interest in other non-interest expense. There were no penalties and interest assessed by taxing authorities during 2010 or 2009.

Advertising Costs

The Bank expenses advertising costs as they are incurred. Total advertising expense was $20,028 and $49,180 for the years ended December 31, 2010 and 2009, 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.

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 $22,818 and $25,520 of compensation expense related to stock-based compensation for options for the years ended December 31, 2010 and 2009, respectively. The financial statements also include $6,666 and $20,000 in stock-based compensation for 2010 and 2009, respectively, 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.

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. The fair value of impaired loans is estimated using discounted cash flow analysis or underlying collateral values, where applicable.

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 time deposits 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 2009 financial statements to conform with current year presentations. Such reclassifications have had no effect upon previously reported net loss.

Note 4 Investment Securities

The amortized cost and fair values of investment securities at December 31, 2010 are as follows:

	December 31, 2010			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
Securities available-for-sale:				
U.S. Government agency mortgage-backed securities	$ 3,586,825	$ 16,195	$ (11,760)	$ 3,591,260
Collateralized mortgage obligations	511,820	-	(5,343)	506,477
SBA pools	4,877,754	4,730	(40,427)	4,842,057
Totals	$ 8,976,399	$ 20,925	$ (57,530)	$ 8,939,794

Note 4 Investment Securities, continued

The balance sheet as of December 31, 2010 reflects the fair value of available-for-sale securities of $8,939,794. A net unrealized loss of $36,605 is in the available-for-sale investment securities balance. The unrealized loss is included in shareholders' equity.

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	$ 17,782,488	$ 263,147	$ (121,775)	$ 17,923,860

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 available-for-sale securities by contractual maturity at December 31, 2010 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, collateralized mortgage obligations 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:		
Mortgage-backed securities	$ 3,586,825	$ 3,591,260
Collateralized mortgage obligations	511,820	506,477
SBA pools	4,877,754	4,842,057
Totals	$ 8,976,399	$ 8,939,794

During 2010, there were proceeds from sales of available-for-sale investment securities in the amount of $15,259,208 which resulted in gross realized gains of $359,221 and gross realized losses of $6,748. 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.

BUSINESS BANK
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 2010 AND 2009

Note 4 Investment Securities, continued

Securities with carrying amounts of $2,126,205 and $9,541,549 at December 31, 2010 and 2009, 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, 2010 and 2009 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, 2010:						
Federal agencies	$ 6,786,992	$ (57,530)	$ -	$ -	$ 6,786,992	$ (57,530)
Totals	$ 6,786,992	$ (57,530)	$ -	$ -	$ 6,786,992	$ (57,530)
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)

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 issuer 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, 2010, there are eighteen investment securities with an unrealized loss of 0.84% 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:

	2010	2009
Commercial	$ 6,195,637	$ 13,705,641
Real Estate	56,166,153	67,427,021
Agriculture	1,083,182	2,828,522
Consumer	417,714	524,979
Overdrafts	1,761	6,131
	63,864,447	84,492,294
Less allowance for loan losses	(4,155,075)	(2,825,208)
Loans, net	$ 59,709,372	$ 81,667,086

Total loans are reported net of deferred loan fees of $12,063 and $104,445 at December 31, 2010 and 2009, respectively. Transactions in the allowance for loan losses are summarized as follows:

	2010	2009
Balance at beginning of year	$ 2,825,208	$ 2,162,497
Provision charged to expense	2,893,797	5,000,979
Loans charged-off	(1,686,921)	(4,514,096)
Recoveries of loans previously charged-off	122,991	175,828
Balance at end of year	$ 4,155,075	$ 2,825,208

At December 31, 2010 and 2009, total nonaccrual loans were $6,598,889 and $7,356,403, respectively. The recorded investment in impaired loans at December 31, 2010 and 2009 is as follows:

	2010	2009
Balance of impaired loans with no allocated allowance	$ 6,469,494	$ 4,529,066
Balance of impaired loans with an allocated allowance	12,623,696	11,594,443
Total recorded investment in impaired loans	$ 19,093,190	$ 16,123,509
Amount of the allowance allocated to impaired loans	$ 1,997,430	$ 1,481,163

The average recorded investment in impaired loans amounted to approximately $17,608,350 and $12,365,000 for the years ended December 31, 2010 and 2009, respectively. Interest income of approximately $455,000 and $358,000 was recognized on these loans during 2010 and 2009. The Bank has no commitments to loan additional funds to borrowers whose loans are impaired. There were no loans past due 90 days or more and still accruing interest at December 31, 2010. Loans past due 90 days or more and still accruing at December 31, 2009 totaled $452,449.

Loans totaling approximately $37,933,000 and $42,588,000 were pledged to secure borrowings at December 31, 2010 and 2009, respectively. Refer to Notes 10 and 11.

Note 6 Premises and Equipment

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

	2010	2009
Land	$ 604,771	$ 604,771
Building	1,732,318	1,732,318
Leasehold improvements	351,665	567,930
Equipment, furniture, and fixtures	926,417	993,060
Total cost	3,615,171	3,898,079
Less accumulated depreciation	(1,052,365)	(908,471)
Total	$ 2,562,806	$ 2,989,608

Depreciation and amortization charged against operations for the years ended December 31, 2010 and 2009 was $292,305 and $308,805, respectively.

The Bank closed its Lynden, Washington office in October 2009. In November 2010, the Bank was released from the lease obligation and paid a total of $24,783 to the landlord in accordance with the lease termination agreement. All leasehold improvements, furniture, fixtures and equipment were written off for a loss of $178,117 in December 2010.

The Bank leases its branch facilities in Bellingham and South Mount Vernon under operating leases with initial lease terms of five years. These leases include renewal options and provide for rate adjustments based on changes in various economic indicators. Gross rental expense was $180,740 for 2010 and $167,946 for 2009 which is included in occupancy and equipment expense.

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, 2010:

2011	$ 97,679
2012	79,192
2013	73,729
Total	$ 250,600

Note 7 Deposits

The composition of deposits at December 31 is as follows:

	2010	2009
Noninterest checking	$ 7,806,755	$ 8,603,341
Interest-bearing checking and money market	15,424,693	16,295,845
Savings deposits	977,203	331,510
Time deposits, less than $100,000	46,272,900	61,648,420
Time deposits, $100,000 or more	3,280,695	6,019,816
Total deposits	$ 73,762,246	$ 92,898,932

Note 7 Deposits, continued

Included in time deposits are brokered deposits of $2,396,264 and $6,714,872 at December 31, 2010 and 2009, respectively. The scheduled maturities of time deposits at December 31, 2010 are as follows:

2011	$ 34,968,752
2012	6,128,809
2013	1,668,184
2014	452,316
2015	6,335,534
Total	$ 49,553,595

Note 8 Federal Income Taxes

No income tax expense or benefit was recorded on the Bank's books during 2010 due to net operating losses incurred. The expense recorded for 2009 relates to the write-off of the deferred tax assets of $508,166.

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

	2010	2009
Deferred tax assets:		
Organizational expenditures	$ 45,199	$ 55,576
Net operating loss carryover	3,281,356	1,487,741
Allowance for possible loan losses in excess of tax reserves	1,045,555	667,250
Basis difference on other real estate owned	145,063	54,120
Off-balance sheet liability	4,892	4,830
Accrual to cash adjustment	-	30,120
Other	1,786	3,680
Total deferred tax asset	4,523,851	2,303,317
Deferred tax liabilities:		
Accrual to cash adjustment	(5,351)	-
Premises and equipment	(76,347)	(102,583)
Other	(14,119)	(13,931)
Total deferred tax liability	(95,817)	(116,514)
Net Deferred Tax Asset	4,428,034	2,186,803
Less Valuation Allowance	(4,428,034)	(2,186,803)
Net deferred tax asset	$ -	$ -

Note 8 Federal Income Taxes, continued

The Bank incurred a net operating loss of approximately $5,080,000 for financial reporting purposes and a taxable loss of $3,642,000 for the year ended December 31, 2010. As of December 31, 2010, the Bank has net operating losses of approximately $9,651,000 which may be carried forward a period of twenty years to offset future taxable income.

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 $4,428,034 and $2,186,803 as of December 31, 2010 and 2009, respectively.

Note 9 Related Party Transactions

During 2010 and 2009, the 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:

	Balance Beginning of Year	Additions	Amounts Collected	Balance End of Year
For the year ended December 31, 2010	$ 2,956,971	$ 61,246	$ (272,288)	$ 2,745,929
For the year ended December 31, 2009	$ 3,714,892	$ 787,214	$ (1,545,135)	$ 2,956,971

The Bank also had unfunded commitments to executive officers, directors and principal shareholders of approximately $334,000 and $609,000 at December 31, 2010 and 2009, respectively.

At December 31, 2010 and 2009, the Bank held related-party deposits of approximately $1,581,000 and $2,417,000, respectively, which includes deposits held for directors, executive officers, principal shareholders, and related business entities.

Note 10 Federal Home Loan Bank Borrowings

The 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, 2010 and 2009 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.

Collateral pledged to the FHLB as of December 31, 2010 and 2009 included loans with outstanding balances of $31,205,574 and $28,661,337, respectively. The Bank has available borrowing capacity of an additional $1,723,378 at December 31, 2010. The Bank was charged a prepayment penalty of $123,393 in May 2010 for prepayment of a $10,000,000 FHLB advance. In September 2009, FHLB charged a prepayment penalty of $41,766 when the Bank repaid a $4,000,000 advance prior to its scheduled maturity.

Advances on these lines at December 31, 2010 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
Total	$	9,000,000

At December 31, 2010, scheduled maturities of the advances are $4,000,000 due in 2013 and $5,000,000 due in 2017 for a total of $9,000,000.

Note 11 Lines of Credit

At December 31, 2010 and 2009, the Bank had available a collateralized line of credit with the Federal Reserve Bank of San Francisco (FRB). Loans with outstanding balances of $6,728,052 and $13,927,091 were pledged to the FRB for available borrowings of $2,617,395 and $4,580,629 at December 31, 2010 and 2009, respectively. There were no outstanding borrowings on this line as of December 31, 2010 or 2009.

At December 31, 2010, the Bank had available a collateralized line of credit with the Pacific Coast Bankers Bank (PCBB). Investments with market value of $1,264,102 were pledged to the PCBB at December 31, 2010 for available borrowings of $1,011,282. There were no outstanding borrowings on this line as of December 31, 2010. This line 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.

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

	2010	2009
Commitments to extend credit	$ 3,447,000	$ 2,924,000
Commercial letters of credit	-	2,603,000
Standby letters of credit	-	5,000

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 2010 or 2009.

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, 2010 and 2009, the Bank had pledged $667,497 and $3,813,901, respectively, 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. In addition, the FDIC insurance coverage has temporarily increased to 100% for noninterest-bearing checking accounts. There were no uninsured deposits at December 31, 2010 or 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.

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 a 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%. At December 31, 2010, the Bank is in substantial compliance with all provisions of the Order with the exception of capital ratios and loan concentration levels. Although concentration of commercial real estate (CRE) and Acquisition, Development and Construction (ADC) loans have been significantly reduced since September 2009, the percentages have not decreased due to decrease in the bank's assets/capital.

Note 14 Regulatory Matters, continued

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:

	Actual		Minimum Required for Capital Adequacy Purposes		Required to be Adequately Capitalized under the Prompt Corrective Action Capital Directive	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of December 31, 2010:						
Tier 1 Capital (to Adjusted Total Average Assets)	$ 5,492	6.34%	$ 3,465	4.00%	$ 8,663	10.00%
Tier 1 Capital (to Risk-weighted Assets)	$ 5,492	8.45%	$ 2,601	4.00%	$ 3,901	6.00%
Total Risk-based Capital (to Risk-weighted Assets)	$ 6,347	9.76%	$ 5,201	8.00%	$ 8,452	13.00%
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%

Note 15 Equity Transactions

The Bank's Articles of Incorporation were amended during 2010 to increase the authorized shares of common stock from 5,000,000 to 10,000,000. The Bank had secondary stock offerings during 2010 and 2009. During 2010, an additional 1,702,595 shares of stock were sold for total proceeds of $2,796,703. During 2009, an additional 181,851 shares of stock were sold for total proceeds of $545,553. Stock proceeds were offset by stock issuance costs of $46,264 and $1,265 for the years ended December 31, 2010 and 2009, respectively.

Note 16 Stock-Based Compensation

Stock Option Plan

In June 2005, the Board of Directors approved the adoption of 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, 2010, 161,500 shares of common stock were reserved for future grants. 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 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.

There were no options granted during 2010. The following assumptions were used to estimate the value of options granted for the year ended December 31, 2009:

	2009
Average expected term	7.0 years
Expected stock price volatility	20.00%
Risk free interest rate	2.36%
Expected dividends	Zero

Note 16 Stock-Based Compensation, continued

Stock Option Plan, continued

Option activity under the Plan for the years ended December 31, 2010 and 2009 is summarized as follows:

Options	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term
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	131,750	10.55	5.47
Vested or expected to vest at December 31, 2009	131,750	10.55	5.47
Exercisable at December 31, 2009	95,650	$ 10.32	5.61
Outstanding at January 1, 2010	131,750	$ 10.55	
Granted	-	-	
Exercised	-	-	
Forfeited or expired	(46,250)	10.09	
Outstanding at December 31, 2010	85,500	10.80	5.11
Vested or expected to vest at December 31, 2010	85,500	10.80	5.11
Exercisable at December 31, 2010	74,750	$ 10.58	4.86

The weighted-average grant-date fair value of options granted during the year ended December 31, 2009, was $1.63. There were no options granted during the year ended December 31, 2010. There were no options exercised during the years ended December 31, 2010 or 2009.

A summary of the status of the Bank's nonvested shares as of December 31, 2010, and changes during the year ended December 31, 2010, is presented below:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2010	36,100	$ 2.08
Granted	-	-
Vested	(15,550)	4.27
Forfeited	(9,800)	2.35
Nonvested at December 31, 2010	10,750	$ 2.06

Note 16 Stock-Based Compensation, continued

Stock Option Plan, continued

As of December 31, 2010, there was $37,397 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 3.25 years.

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

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Number Exercisable
$ 10.00	59,000	4.44	59,000
10.50	2,000	5.48	1,400
11.35	5,000	5.76	4,000
14.00	14,750	6.66	8,850
13.50	2,750	7.55	1,100
5.88	2,000	8.18	400
Total	85,500		74,750

Restricted Stock

In April 2005 the Bank granted an employee 10,000 shares of restricted common stock with a graded vesting period over 5 years. There have been no grants of restricted common stock since. For the year ended December 31, 2010, 667 shares of restricted common stock were vested. The Bank's statements of operations include $6,666 and $20,000 of compensation expense related to restricted stock-based compensation for the years ended December 31, 2010 and 2009, respectively. As of December 31, 2010, there was no remaining unrecognized compensation for restricted common stock.

Stock Warrants

In June 2005 the Board of Directors authorized the granting of stock warrants to the Bank's organizers in exchange for providing $700,000 in seed capital which funded the organizational expenses of the Bank. Each Director (8) received 8,750 warrants that entitles the holder to purchase one share of common stock at a price of $10.00 per share on or before May 31, 2015. All 70,000 warrants remain outstanding as of December 31, 2010 and 2009.

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. There was no employer match for 2010. Total 401(k) expense was $3,010 for the year ended 2009.

Note 18 Fair Values of Financial Instruments

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

	2010		2009	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 1,065	$ 1,065	$ 1,517	$ 1,517
Interest-bearing deposits with financial institutions	10,207	10,207	8,687	8,687
Investment securities	8,940	8,940	17,924	17,924
Federal Home Loan Bank stock	1,107	1,107	1,074	1,074
Pacific Coast Bankers' Bank stock	190	190	190	190
Loans held-for-sale	-	-	208	208
Loans, net	59,709	60,147	81,667	82,792
Interest receivable	225	225	378	378
Financial liabilities:				
Deposits	73,762	73,894	92,899	92,951
FHLB borrowings	9,000	9,663	19,000	19,857
Interest payable	107	107	255	255

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

Note 19 Fair Value Measurements

The Bank has adopted authoritative guidance issued by the FASB regarding fair value measurements for financial assets and financial liabilities. The authoritative guidance defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements.

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.

Note 19 Fair Value Measurements, continued

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.

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.

Note 19 Fair Value Measurements, continued

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.

Other Real Estate: Other real estate represents foreclosed assets that are reported at the fair value less estimated selling costs of the underlying property. The fair values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on information obtained from customized discounting criteria.

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 and 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2010:				
Available-For-Sale:				
U.S. Government agency mortgage-backed securities	$ -	$ 3,591,260	$ -	$ 3,591,260
Collateralized mortgage obligations	-	506,477	-	506,477
SBA pools	-	4,842,057	-	4,842,057
Totals	$ -	$ 8,939,794	$ -	$ 8,939,794
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	$ -	$ 17,923,860	$ -	$ 17,923,860

Certain financial assets are measured at fair value on a non-recurring 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). Financial assets measured at fair value on a non-recurring basis include certain impaired loans 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.

Note 19 Fair Value Measurements, continued

The following table summarizes financial assets measured at fair value on a non-recurring basis as of December 31, 2010 and 2009, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure the fair value:

	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
December 31, 2010:				
Impaired loans	$ -	$ 14,983,230	$ 4,074,078	$ 19,057,308
Less specific valuation allowance for possible loan losses	-	(1,633,643)	(363,664)	(1,997,307)
Impaired loans, net	$ -	$ 13,349,587	$ 3,710,414	$ 17,060,001
December 31, 2009:				
Impaired loans	$ -	$ 12,307,090	$ 3,816,419	$ 16,123,509
Less specific valuation allowance for possible loan losses	-	(942,469)	(538,694)	(1,481,163)
Impaired loans, net	$ -	$ 11,364,621	$ 3,277,725	$ 14,642,346

Certain nonfinancial assets are measured at fair value on a non-recurring basis. Nonfinancial assets measured at fair value on a non-recurring basis include other real estate which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain other real estate, which subsequent to their initial recognition, were remeasured at fair value through a writedown included in other non-interest expense. The fair value of other real estate is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. At December 31, 2010 and 2009, the Bank had other real estate totaling $4,291,658 and $5,554,348, respectively. Fair values were determined using Level 2 measurements. There were $117,542 and $1,049,652 in charge-offs included in the allowance for loan losses and $823,037 and $188,816 in subsequent writedowns included in other non-interest expense for impairment on other real estate at December 31, 2010 and 2009, respectively.

Note 20 Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before the financial statements are available to be issued. The Bank recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Bank's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date and before the financial statements are available to be issued. The Bank has evaluated subsequent events from December 31, 2010 through April 22, 2011 the date the financial statements were available to be issued. The following item was identified for disclosure:

Since December 31, 2010, the Bank has raised additional capital by selling 957,994 shares of common stock for net proceeds of $1,524,322. The stock offering which commenced in September 2010 was terminated as of March 31, 2011.