# ALTAPACIFIC BANCORP

## CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2011 and 2010

# REPORT OF INDEPENDENT AUDITORS

The Shareholders and Board of Directors
AltaPacific Bancorp
Santa Rosa, California

We have audited the accompanying consolidated balance sheet of AltaPacific Bancorp, (the "Company") as of December 31, 2011 and the related consolidated statements of income, changes in shareholders' equity and comprehensive income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The 2010 financial statements of AltaPacific Bancorp were audited by Perry-Smith LLP, who combined with Crowe Horwath LLP as of November 1, 2011, and whose report dated March 14, 2011 expressed an unqualified opinion on those financial statements.

We conducted our audit 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 consolidated 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 audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AltaPacific Bancorp as of December 31, 2011 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.

Crowe Horwath LLP

Crowe Horwath LLP

Sacramento, California
March 20, 2012

**ALTAPACIFIC BANCORP**

**CONSOLIDATED BALANCE SHEETS**

**December 31, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 2,055,000 | $ 790,000 |
| Federal funds sold | 2,005,000 | 1,510,000 |
| Total cash and cash equivalents | 4,060,000 | 2,300,000 |
| Interest-bearing deposits in banks | 249,000 | 3,287,000 |
| Available-for-sale investment securities (Note 2) | 41,548,000 | 9,645,000 |
| Loans, less allowance for loan losses of $1,300,000 in 2011 and $1,423,000 in 2010 (Notes 3, 4 and 9) | 58,574,000 | 60,132,000 |
| Premises and equipment, net (Note 5) | 739,000 | 625,000 |
| Other real estate owned | 766,000 | 781,000 |
| Bank owned life insurance | 5,051,000 | |
| Accrued interest receivable and other assets | 4,332,000 | 3,027,000 |
| | $ 115,319,000 | $ 79,797,000 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Deposits: | | |
| Non-interest bearing | $ 18,783,000 | $ 8,608,000 |
| Interest bearing (Note 6) | 57,617,000 | 38,531,000 |
| Total deposits | 76,400,000 | 47,139,000 |
| Other borrowings (Note 8) | 12,000,000 | 5,000,000 |
| Accrued interest payable and other liabilities | 585,000 | 608,000 |
| Total liabilities | 88,985,000 | 52,747,000 |
| Commitments and contingencies (Note 9) | | |
| Shareholders' equity (Notes 10 and 11): | | |
| Preferred stock – no par value; 10,000,000 shares authorized, none issued or outstanding | - | - |
| Common stock – no par value; 40,000,000 shares authorized; 3,183,360 shares issued and outstanding in 2011 and 2010 | 29,069,000 | 29,027,000 |
| Accumulated deficit | (1,479,000) | (1,783,000) |
| Accumulated other comprehensive loss | (1,256,000) | (194,000) |
| Total shareholders' equity | 26,334,000 | 27,050,000 |
| Total liabilities and shareholders' equity | $ 115,319,000 | $ 79,797,000 |

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

**ALTAPACIFIC BANCORP**

**CONSOLIDATED STATEMENTS OF INCOME**

**For the Years Ended December 31, 2011 and 2010**

| | 2011 | 2010 |
|---|---|---|
| Interest income: | | |
| Interest and fees on loans | $ 4,485,000 | $ 4,676,000 |
| Interest on available-for-sale investment securities | 1,147,000 | 811,000 |
| Interest on deposits in banks | 17,000 | 112,000 |
| Interest on Federal funds sold | 19,000 | 10,000 |
| Total interest income | 5,668,000 | 5,609,000 |
| Interest expense: | | |
| Interest on deposits (Note 6) | 454,000 | 503,000 |
| Interest on short-term borrowings | 62,000 | 6,000 |
| Total interest expense | 516,000 | 509,000 |
| Net interest income | 5,152,000 | 5,100,000 |
| Provision for loan losses (Note 4) | (123,000) | 785,000 |
| Net interest income after provision for loan losses | 5,275,000 | 4,315,000 |
| Non-interest income: | | |
| Service charges and fees | 73,000 | 11,000 |
| Other-than-temporary impairment loss | | |
| Total impairment loss | (126,000) | |
| Loss recognized in other comprehensive income | 6,000 | |
| Net impairment loss recognized in earnings | (120,000) | |
| Total non-interest income | (47,000) | 11,000 |
| Non-interest expense: | | |
| Salaries and employee benefits (Notes 3 and 13) | 2,726,000 | 2,273,000 |
| Occupancy and equipment (Notes 5 and 9) | 530,000 | 482,000 |
| Other (Note 13) | 1,306,000 | 1,079,000 |
| Total non-interest expense | 4,562,000 | 3,834,000 |
| Income before income taxes | 666,000 | 492,000 |
| Income tax expense (benefit) (Note 7) | 362,000 | (410,000) |
| Net income | 304,000 | 902,000 |
| Basic earnings per share | $ 0.10 | $ 0.28 |
| Diluted earnings per share | $ 0.10 | $ 0.28 |
| Weighted average number of shares outstanding – basic | 3,183,360 | 3,183,360 |
| Weighted average number of shares outstanding – diluted | 3,196,268 | 3,229,881 |

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

**ALTAPACIFIC BANCORP**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME**

**For the Years Ended December 31, 2011 and 2010**

| | Common Stock | | | | | |
|---|---|---|---|---|---|---|
| | Shares | Amount | Accumulated Deficit | Accumulated Other Compre-hensive Loss | Total Shareholders' Equity | Compre-hensive Income (Loss) |
| Balance, January 1, 2010 | 3,183,360 | $ 28,826,000 | $ (2,685,000) | $ (1,130,000) | $ 25,011,000 | |
| Share-based compensation (Note 10) | | 201,000 | | | 201,000 | |
| Comprehensive income: | | | | | | |
| Net income | | | 902,000 | | 902,000 | $ 902,000 |
| Other comprehensive income: | | | | | | |
| Unrealized gain on available-for-sale investment securities, net of tax (Note 2) | | | | 936,000 | 936,000 | 936,000 |
| | | | | | | $ 1,838,000 |
| Balance, December 31, 2010 | 3,183,360 | 29,027,000 | (1,783,000) | (194,000) | 27,050,000 | |
| Share-based compensation (Note 10) | | 42,000 | | | 42,000 | |
| Comprehensive income (loss): | | | | | | |
| Net income | | | 304,000 | | 304,000 | $ 304,000 |
| Other comprehensive loss: | | | | | | |
| Unrealized loss on available-for-sale investment securities, net of tax (Note 2) | | | | (1,133,000) | (1,133,000) | (1,133,000) |
| Reclassification of other-than-temporary impairment recognized in earnings, net of tax | | | | 71,000 | 71,000 | 71,000 |
| Total other comprehensive loss | | | | | | (1,062,000) |
| | | | | | | $ (758,000) |
| Balance, December 31, 2011 | 3,183,360 | $ 29,069,000 | $ (1,479,000) | $ (1,256,000) | $ 26,334,000 | |

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

## ALTAPACIFIC BANCORP

## CONSOLIDATED STATEMENTS OF CASH FLOWS

### For the Years Ended December 31, 2011 and 2010

| | 2011 | 2010 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 304,000 | $ 902,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | (123,000) | 785,000 |
| Other than temporary impairment | 120,000 | |
| Depreciation and amortization, net | 455,000 | 18,000 |
| Loss on disposal of premises and equipment | | |
| Deferred loan origination costs and fees, net | 16,000 | 21,000 |
| Share-based compensation | 42,000 | 201,000 |
| Increase in cash surrender value of life insurance | (51,000) | |
| Deferred tax expense (benefit) | 214,000 | (132,000) |
| Change in valuation allowance on deferred tax assets | | (665,000) |
| (Increase) decrease in accrued interest receivable and other assets | (565,000) | 330,000 |
| Decrease in accrued interest payable and other liabilities | (23,000) | (9,000) |
| Net cash provided by operating activities | 389,000 | 1,451,000 |
| Cash flows from investing activities: | | |
| Purchase of life insurance | (5,000,000) | |
| Net decrease in interest bearing deposits in banks | 3,038,000 | 6,804,000 |
| Purchase of available-for-sale investment securities | (39,042,000) | (2,167,000) |
| Purchase of Federal Reserve Bank stock | (31,000) | (775,000) |
| Purchase of Federal Home Loan Bank stock | (185,000) | (21,000) |
| Proceeds from principal payments of mortgage-backed securities | 4,980,000 | 2,736,000 |
| Decrease (increase) in loans funded, net | 1,665,000 | (1,451,000) |
| Purchase of premises and equipment | (330,000) | (50,000) |
| Proceeds from other real estate owned | 15,000 | |
| Net cash (used in) provided by investing activities | (34,890,000) | 5,076,000 |
| Cash flows from financing activities: | | |
| Increase in demand and money market deposits, net | 30,025,000 | 7,829,000 |
| Decrease in time deposits, net | (764,000) | (11,247,000) |
| Proceeds from other borrowings | 12,000,000 | 5,000,000 |
| Repayment of other borrowings | (5,000,000) | (7,500,000) |
| Net cash provided by (used in) financing activities | 36,261,000 | (5,918,000) |
| Increase in cash and cash equivalents | 1,760,000 | 609,000 |
| Cash and cash equivalents at beginning of period | 2,300,000 | 1,691,000 |
| Cash and cash equivalents at end of year | $ 4,060,000 | $ 2,300,000 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the year for interest expense | $ 517,000 | $ 516,000 |
| Cash paid during the year for income taxes | $ 479,000 | $ 168,000 |
| Non-cash investing activities: | | |
| Other real estate owned acquired through foreclosure | $ - | $ 781,000 |

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

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### The Company

AltaPacific Bancorp was incorporated as a bank holding company for the purpose of acquiring AltaPacific Bank (the "Bank") in a one bank holding company reorganization. The new corporate structure gives the Company and the Bank greater flexibility in terms of operation, expansion and diversification. The reorganization was approved by the Bank's shareholders on May 13, 2010, and all required regulatory approvals with respect to the reorganization were obtained. The reorganization was consummated in March 2010, subsequent to which the Bank continued its operations as previously conducted but as a wholly-owned subsidiary of AltaPacific Bancorp.

AltaPacific Bancorp's principal business is to serve as a holding company for the Bank and its principal source of income will be derived from dividends paid by the Bank. The payment of dividends by the Bank is subject to restrictions that could limit AltaPacific Bancorp's payment of dividends to its shareholders.

### The Bank

AltaPacific Bank was organized under the laws of the State of California on February 16, 2006. The Bank opened for business as a state-chartered non-member Bank on July 10, 2006. On November 5, 2010, the Company became a member of the Federal Reserve System (FRB). On August 3, 2009, the Bank amended its articles of incorporation to change its legal name from Atlantic Pacific Bank to AltaPacific Bank.

The Bank is subject to regulation by the California Department of Financial Institutions (the "DFI") and the FRB and its deposits are insured by the Federal Deposit Insurance Corporation up to applicable legal limits. The Bank is headquartered in Santa Rosa, California and also has branch offices in Rancho Cucamonga, California. The Bank provides products and services to customers who are predominately small to middle-market business, professionals and not-for-profit organizations.

Generally, deposits are insured by the FDIC up to $250,000 per depositor. Through December 31, 2012, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC for the entire amount in the account.

### Principles of Consolidation

The accounting and reporting policies of AltaPacific Bancorp and its subsidiary AltaPacific Bank (collectively, "the Company") conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. Significant inter-company balances and transactions have been eliminated through consolidation.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Operating Segments

While the Company's executive officers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Operating results are not reviewed by senior management to make resource allocation or performance decisions. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

Reclassifications

Certain reclassifications have been made to the prior year's balances to conform to the classifications used in the current year.

Subsequent Events

Management has reviewed all events occurring from December 31, 2011 through March 20, 2012, the date the financial statements were available to be issued.

Use of 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. These estimates and assumptions affect the reported amounts of 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 these estimates. The allowance for loan losses, deferred tax assets and fair values of financial instruments are particularly subject to change.

Cash and Cash Equivalents

For the purpose of the consolidated statement of cash flows, cash and cash equivalents consist of cash and due from banks and Federal funds sold. Generally, Federal funds are sold for one day periods.

Investment Securities

Investment securities are classified into the following categories:

- Available-for-sale securities, reported at fair value, with unrealized gains and losses, to the extent losses are not considered other than temporary, excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.

- Held-to-maturity securities, which management has the positive intent and ability to hold, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Investment Securities (Continued)

Management determines the appropriate classification of its investments at the time of purchase and may only change the classification in certain limited circumstances. All transfers between categories are accounted for at fair value. At December 31, 2011 and 2010, all securities are classified as available-for-sale and there were no transfers between categories for the years ended December 31, 2011 and 2010.

Gains and losses on the sale of investment securities are computed using the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums.

An investment security is impaired when its carrying value is greater than its fair value. Investment securities that are impaired are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether such a decline in their fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Company to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not that the Company will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Company will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Loans

Loans are stated at principal balances outstanding. Interest is accrued daily based upon outstanding loan balances. However, when, in the opinion of management, loans are considered to be impaired and the future collectibility of interest and principal is in serious doubt, loans are placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans, or payments received on nonaccrual loans for which the ultimate collectibility of principal is not in doubt, are applied first to earned but unpaid interest and then to principal. Generally, loans are placed on non-accrual status when they are 90 days past due. Past due status is based on the contractual terms of the loan. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. The Company's policy for placing loans on nonaccrual status, recording payments received on nonaccrual loans, resuming accrual of interest and determining past due or delinquency status does not differ by portfolio segment, nor does it differ for loans modified in troubled debt restructurings.

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Loans (Continued)

All classified loans are evaluated for impairment and are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (including both principal and interest) in accordance with the contractual terms of the loan agreement. The policy for recognizing interest on impaired loans is the same as the policy described above and does not differ by portfolio segment.

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described below.

Substantially all loan origination fees, commitment fees, direct loan origination costs and purchase premiums and discounts on loans are deferred and recognized as an adjustment of yield, to be amortized to interest income over the contractual term of the loan. The unamortized balance of deferred fees and costs is reported as a component of net loans.

Allowance for Loan Losses

The allowance for loan losses is an estimate of credit losses inherent in the Company's loan portfolio that have been incurred as of the balance-sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The policy for charging off loans and recording recoveries on previously charged off loans does not differ by portfolio segment. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are not impaired.

Loans determined to be impaired are individually evaluated for impairment. When a loan is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. The policy for measuring impaired loans does not differ by portfolio segment.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

The determination of the general reserve for loans that are not impaired is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors to include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial, commercial real estate construction (including land and development loans), commercial real estate mortgage, installment and home equity lines of credit. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Company's overall allowance, which is included on the balance sheet.

The Company assigns a risk rating to all loans and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Company and the Company's regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings do not differ by portfolio segment, and can be grouped into five major categories, defined as follows:

***Pass*** – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

***Special Mention*** – A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Company's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

***Substandard*** – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

***Doubtful*** – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

***Loss*** – Loans classified as loss are considered uncollectible and charged off immediately.

The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk, (2) historical losses and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

***Commercial*** – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

***Real estate construction*** – Commercial real estate construction loans (including land and development loans) generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

***Real estate mortgage*** – Commercial real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

***Consumer installment*** – An installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Allowance for Loan Losses (Continued)

***Consumer other: home equity lines of credit*** – The degree of risk in the home equity lines of credit portfolio depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's primary regulators, the FRB and California Department of Financial Institutions, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

There were no significant changes to the Company's accounting policies or methodologies with respect to the allowance for loan losses from the prior year.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the balance sheet.

Premises and Equipment

Premises and equipment are carried at cost. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of furniture, fixtures and equipment are estimated to be 3 to 10 years. Leasehold improvements are amortized over the lesser of the respective lease term (including renewal periods that are reasonably assured) or their useful lives, which are generally 3 to 10 years. Leased equipment meeting certain capital lease criteria is capitalized and the present value of the related lease payments is recorded as a liability. Amortization of capital leases is computed using a straight-line method over the shorter of the estimated and useful life of the equipment or the initial lease term.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Premises and Equipment (Continued)

Certain operating leases contain scheduled and specified rent increases or incentives in the form of tenant improvement allowances or credits. The scheduled rent increases are recognized on a straight-line basis over the lease term as an increase in the amount of rental expense recognized each period. Lease incentives, including tenant improvement credits, are capitalized at the inception of the lease and amortized on a straight-line basis over the lease term as a reduction of rental expense. Amounts accrued in excess of amounts paid related to the scheduled rent increases and the unamortized deferred tenant improvement credits are included in accrued interest payable and other liabilities on the balance sheet.

When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. The Company evaluates premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

Federal Home Loan Bank and Federal Reserve Bank Stock

The Company, as a member of the Federal Home Loan Bank of San Francisco (FHLB) and the FRB, is required to hold shares of capital stock in the FHLB and FRB in an amount specified by regulation and is adjusted periodically based on a determination made by the FHLB and FRB. At December 31, 2011 and 2010, the Company owned $564,000 and $379,000, respectively, of FHLB stock. At December 31, 2011 and 2010, the Company owned $806,000 and $775,000, respectively, of FRB stock.

These investments are recorded at cost, carried as restricted securities, and are periodically evaluated for impairment. Cash and stock dividends are both reported as income. These stocks are included in accrued interest receivable and other assets on the balance sheet.

Other Real Estate Owned

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed.

Bank Owned Life Insurance

The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates which are expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The Company considers all tax positions recognized in its financial statements for the likelihood of realization. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than fifty percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above, if any, is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the statement of operations. The Company does not have a liability for unrecognized tax benefits, or uncertain tax positions, and has not accrued for any interest or penalties as of December 31, 2011.

Earnings Per Share

Basic earnings per share (EPS), which excludes dilution, is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which shares in the earnings of the Company. The treasury stock method is applied to determine the dilutive effect of stock options in computing diluted earnings per share. Stock options totaling 523,230 and 3,308 for the years ended December 31, 2011 and 2010, respectively, were considered anti-dilutive and were excluded from the computation of diluted earnings per share because the assumed proceeds from exercise price, tax benefits and average future compensation exceeded the average market price of the Company's common stock.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Share-Based Compensation

The Company has one share-based compensation plan, the Atlantic Pacific Bank 2006 Equity Incentive Plan (the "Plan"), which has been approved by its shareholders and permits the grant of stock options and restricted stock for up to 955,040 shares of the Company's common stock of which 386,294 were available for future grants at December 31, 2011. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Company's operating results and government regulations. New shares are issued upon option exercise or restricted share grants. The Plan does not provide for the settlement of awards in cash. The Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised. All options expire on a date determined by the Board of Directors but not later than ten years from the date of grant. The vesting period is determined by the Board of Directors and is generally over a three to five year period.

Restricted stock awards are grants of shares of common stock that are subject to forfeiture until specific conditions or goals are met. Conditions may be based on continuing employment or achieving specified performance goals. During the period of restriction, participants holding restricted stock may have full voting and dividend rights. The restrictions lapse in accordance with a schedule or with other conditions determined by the board of directors. There have been no restricted stock awards granted since inception of the Company or its subsidiary.

The Company accounts for share-based compensation using a fair-value based method and requires that share-based compensation expense be recorded for all stock options that are ultimately expected to vest as the requisite service is rendered.

Management estimates the fair value of each option award as of the date of grant using a Black-Scholes-Merton option pricing formula and the following assumptions. Expected volatility is based on historical volatility of the Company's common stock over a preceding period commensurate with the expected term of the option. The "simplified" method described in the Securities and Exchange Commission's Staff Accounting Bulletin No. 110 is used to determine the expected term of the options. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant with substantially the same term as the expected term of the option. Expected dividend yield was not considered in the option pricing formula since cash dividends have not been paid and there are no current plans to do so in the foreseeable future. In addition to these assumptions, management makes estimates regarding pre-vesting forfeitures that will impact total compensation expense recognized under the Plan.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Comprehensive Income

Comprehensive income is reported in addition to net income for all periods presented. Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income or loss that historically has not been recognized in the calculation of net income. Unrealized gains and losses on the Company's available-for-sale investment securities are included in other comprehensive income, adjusted for realized gains or losses included in net income. Total comprehensive income or loss and the components of accumulated other comprehensive income or loss are presented in the statement of changes in shareholders' equity and comprehensive income.

Adoption of New Financial Accounting Standards

In April 2011, the FASB amended existing guidance for assisting a creditor in determining whether a restructuring is a troubled debt restructuring. The amendments clarify the guidance for a creditor's evaluation of whether it has granted a concession and whether a debtor is experiencing financial difficulties. With regard to determining whether a concession has been granted, the ASU clarifies that creditors are precluded from using the effective interest method to determine whether a concession has been granted. In the absence of using the effective interest method, a creditor must now focus on other considerations such as the value of the underlying collateral, evaluation of other collateral or guarantees, the debtor's ability to access other funds at market rates, interest rate increases and whether the restructuring results in a delay in payment that is insignificant. This guidance was adopted by the Company retrospectively to January 1, 2011, and adoption did not have a material effect on the Company's operating results or financial condition.

In May, 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and International accounting principles. Overall, the guidance is consistent with existing U.S. accounting principles; however, there are some amendments that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The amendments in this guidance are effective for interim and annual reporting periods beginning after December 15, 2011. The adoption of this guidance is not expected to have a material effect on the Company's operating results or financial condition.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Adoption of New Financial Accounting Standards (Continued)

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholder's equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective as of the beginning of a fiscal reporting year, and interim periods within that year, that begins after December 15, 2011. Early adoption is permitted. The adoption of this amendment will change the presentation of the components of comprehensive income for the Company as part of the consolidated statement of shareholder's equity.

## 2. AVAILABLE-FOR-SALE INVESTMENT SECURITIES

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2011 and 2010 consisted of the following:

| | 2011 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Corporate securities | $ 10,605,000 | | $ (1,015,000) | $ 9,590,000 |
| Mortgage-backed securities-residential: | | | | |
| Agency | 26,027,000 | $ 68,000 | (297,000) | 25,798,000 |
| Non-agency | 7,045,000 | 3,000 | (888,000) | 6,160,000 |
| | $ 43,677,000 | $ 71,000 | $ (2,200,000) | $ 41,548,000 |

| | 2010 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities-residential: | | | | |
| Agency | $ 2,939,000 | $ 43,000 | $ (3,000) | $ 2,979,000 |
| Non-agency | 7,035,000 | 273,000 | (642,000) | 6,666,000 |
| | $ 9,974,000 | $ 316,000 | $ (645,000) | $ 9,645,000 |

Net unrealized losses on available-for-sale investment securities totaling $1,800,000 were recorded net of $738,000 in tax benefits, as other comprehensive loss within shareholders' equity for the year ended December 31, 2011. Net unrealized gains on available-for-sale investment securities totaling $801,000 were recorded net of $135,000 in tax benefits, as other comprehensive income within shareholders' equity for the year ended December 31, 2010. There were no sales, calls or transfers of available-for-sale investment securities for the year ended December 31, 2011 or 2010.

## 2. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

Investment securities with unrealized losses at December 31, 2011 and 2010 are summarized and classified according to the duration of the loss period as follows:

| | 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Corporate securities | $ 9,590,000 | $ (1,015,000) | | | $ 9,590,000 | $ (1,015,000) |
| Mortgage-backed securities-residential: | | | | | | |
| Agency | 21,111,000 | (296,000) | $ 305,000 | $ (1,000) | 21,416,000 | (297,000) |
| Non-agency | 2,217,000 | (117,000) | 2,859,000 | (771,000) | 5,076,000 | (888,000) |
| | $ 32,918,000 | $ (1,428,000) | $ 3,164,000 | $ (772,000) | $ 36,082,000 | $ (2,200,000) |

| | 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed Securities-resdential: | | | | | | |
| Agency | $ 909,000 | $ (3,000) | | | $ 909,000 | $ (3,000) |
| Non-agency | | | $ 3,891,000 | $ (642,000) | 3,891,000 | (642,000) |
| | $ 909,000 | $ (3,000) | $ 3,891,000 | $ (642,000) | $ 4,800,000 | $ (645,000) |

The Company held nine corporate securities, all of which were in an unrealized loss position as of December 31, 2011 and had been in an unrealized loss position for less than 12 months. The Company held twenty agency residential mortgage-backed securities of which sixteen were in an unrealized loss position as of December 31, 2011 and eight non-agency residential mortgage-backed securities of which seven were in an unrealized loss position as of December 31, 2011. Fifteen agency residential mortgage-backed securities had been in an unrealized loss position for less than twelve months and seven non-agency residential mortgage-backed securities had been in an unrealized loss position for more than 12 months. These unrealized losses were primarily caused by illiquidity in the marketplace and downgrades made by the rating agencies of the issuers. Management performed an impairment analysis using detailed cash flow analysis to determine the recoverability of all principal and interest contractually due. This analysis projects prepayments, expected housing price changes, delinquency and default rates, expected loss severities, and interest rates, while factoring in the underlying collateral. Upon completion of the December 31, 2011 analysis, management determined there was other-than-temporary impairment on two of these securities, both of which experienced additional defaults during the year. These two securities had increases in unrealized losses of $126,000 in 2011, of which $120,000 was recorded as expense and $6,000 was recorded in other comprehensive loss. These two securities remained classified as available for sale at December 31, 2011, and together, the two securities accounted for $218,000 of the unrealized loss in the residential mortgage-backed securities - agency category at December 31, 2011. For all securities in an unrealized loss position other than these two securities, based on management's analysis, and because management does not have the intent to sell these securities nor does management believe it is more likely than not that the Company will be required to sell these securities before a recovery of amortized cost, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2011 and 2010.

## 2. AVAILABLE-FOR-SALE INVESTMENT SECURITIES (Continued)

The table below presents a rollforward for the year ended December 31, 2011 of the credit losses recognized in earnings:

| | 2011 |
|---|---|
| Beginning balance, January 1, 2011 | $ - |
| Additions for credit losses on securities for which no previous other-than-temporary impairment was recognized | 120,000 |
| Ending balance, December 31, | $ 120,000 |

The amortized cost and estimated fair value of available-for-sale investment securities at December 31, 2011 by contractual maturity are shown below.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Corporate securities | | |
| After five years | $ 10,605,000 | $ 9,590,000 |
| Mortgage-backed securities | | |
| Agency | | |
| One through five years | 474,000 | 476,000 |
| Five through ten years | 3,022,000 | 3,078,000 |
| After ten years | 22,531,000 | 22,244,000 |
| | 26,027,000 | 25,798,000 |
| Non-agency | | |
| After ten years | 7,045,000 | 6,160,000 |
| | $ 43,677,000 | $ 41,548,000 |

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties.

Investment securities with amortized cost totaling $26,027,000 and estimated fair values totaling $25,798,000 were pledged to secure borrowings with the Federal Home Loan Bank at December 31, 2011. Investment securities with amortized cost totaling $3,860,000 and estimated fair values totaling $3,940,000 were pledged to secure borrowings with the Federal Home Loan Bank at December 31, 2010 (see Note 8).

## 3. LOANS

Outstanding loans are summarized below:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Commercial | $ 6,438,000 | $ 7,591,000 |
| Real estate – construction | 24,227,000 | 24,293,000 |
| Real estate – mortgage | 25,158,000 | 23,504,000 |
| Consumer and other | 4,350,000 | 6,450,000 |
| | 60,173,000 | 61,838,000 |
| Deferred loan origination fees, net | (299,000) | (283,000) |
| Allowance for loan losses | (1,300,000) | (1,423,000) |
| | $ 58,574,000 | $ 60,132,000 |

Salaries and employee benefits totaling $97,000 and $70,000 were deferred as loan origination costs for the years ended December 31, 2011 and 2010, respectively.

Certain loans are pledged as collateral for available borrowings with the FHLB. Pledged loans totaled $27,644,000 and $31,458,000 at December 31, 2011 and 2010, respectively (see Note 8).

At December 31, 2011 and 2010 there were no loans on nonaccrual status or loans past due 90 days or more and still accruing interest. There was no interest foregone an nonaccrual loans for the year ended December 31, 2011. Interest foregone on nonaccrual loans totaled $69,000 for the year ended December 31, 2010.

## 4. ALLOWANCE FOR LOAN LOSSES

Changes in the allowance for loan losses were as follows:

| | Year Ended December 31, 2011 | Year Ended December 31, 2010 |
|---|---|---|
| Balance, beginning of year | $ 1,423,000 | $ 1,251,000 |
| Provision for loan losses | (123,000) | 785,000 |
| Losses charged to the allowance | | (613,000) |
| Balance, end of year | $ 1,300,000 | $ 1,423,000 |

## 4. ALLOWANCE FOR LOAN LOSSES (Continued)

Changes in the allowance for loan losses by portfolio segment for the year ended December 31, 2011 were as follows:

| | Commercial | Real Estate – Construction | Real Estate – Mortgage | Installment | Home Equity Lines of Credit | Total |
|---|---|---|---|---|---|---|
| Balance, beginning of year | $ 156,000 | $ 816,000 | $ 344,000 | $ 54,000 | $ 53,000 | $ 1,423,000 |
| Provision charged to operations | (11,000) | (221,000) | 157,000 | (16,000) | (32,000) | (123,000) |
| Balance, end of year | $ 145,000 | $ 595,000 | $ 501,000 | $ 38,000 | $ 21,000 | $ 1,300,000 |

The following table shows the allocation of the allowance for loan losses at December 31, 2011 and 2010 by portfolio segment and by impairment methodology:

| | Commercial | Commercial Real Estate – Construction | Commercial Real Estate – Mortgage | Installment | Home Equity Lines of Credit | Total |
|---|---|---|---|---|---|---|
| *Allowance for Loan Losses* | | | | | | |
| December 31, 2011 | | | | | | |
| Ending balance allocated to portfolio segments | $ 145,000 | $ 595,000 | $ 501,000 | $ 38,000 | $ 21,000 | $ 1,300,000 |
| Ending balance: individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Ending balance: collectively evaluated for impairment | $ 145,000 | $ 595,000 | $ 501,000 | $ 38,000 | $ 21,000 | $ 1,300,000 |
| December 31, 2010 | | | | | | |
| Ending balance allocated to portfolio segments | $ 156,000 | $ 816,000 | $ 344,000 | $ 54,000 | $ 53,000 | $ 1,423,000 |
| Ending balance: individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Ending balance: collectively evaluated for impairment | $ 156,000 | $ 816,000 | $ 344,000 | $ 54,000 | $ 53,000 | $ 1,423,000 |
| *Loans* | | | | | | |
| December 31, 2011 | | | | | | |
| Ending balance | $ 6,438,000 | $24,227,000 | $25,158,000 | $ 3,350,000 | $ 1,000,000 | $60,173,000 |
| Ending balance: individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Ending balance: collectively evaluated for impairment | $ 6,438,000 | $24,227,000 | $25,158,000 | $ 3,350,000 | $ 1,000,000 | $60,173,000 |
| December 31, 2010 | | | | | | |
| Ending balance | $ 7,591,000 | $24,293,000 | $23,504,000 | $ 5,019,000 | $ 1,431,000 | $61,838,000 |
| Ending balance: individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Ending balance: collectively evaluated for impairment | $ 7,591,000 | $24,293,000 | $23,504,000 | $ 5,019,000 | $ 1,431,000 | $61,838,000 |

## 4. ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2011 and 2010:

| | Credit Risk Profile by Internally Assigned Grade | | | | | |
|---|---|---|---|---|---|---|
| | Commercial | Real Estate – Construction | Real Estate – Mortgage | Installment | Home Equity Lines of Credit | Total |
| December 31, 2011 | | | | | | |
| Grade: | | | | | | |
| Pass | $ 6,051,000 | $24,227,000 | $25,158,000 | $ 3,350,000 | $ 1,000,000 | $59,786,000 |
| Special Mention | 244,000 | | | | | 244,000 |
| Substandard | 143,000 | | | | | 143,000 |
| Total | $ 6,438,000 | $24,227,000 | $25,158,000 | $ 3,350,000 | $ 1,000,000 | $60,173,000 |
| December 31, 2010 | | | | | | |
| Grade: | | | | | | |
| Pass | $ 6,319,000 | $24,293,000 | $23,504,000 | $ 5,019,000 | $ 1,431,000 | $60,566,000 |
| Special Mention | 467,000 | | | | | 467,000 |
| Substandard | 805,000 | | | | | 805,000 |
| Total | $ 7,591,000 | $24,293,000 | $23,504,000 | $ 5,019,000 | $ 1,431,000 | $61,838,000 |

The Company did not have any impaired loans at December 31, 2011 or 2010. The average outstanding balance of impaired loans for the years ended December 31, 2011 and 2010 was $0 and $680,000, respectively, on which no interest income was recognized on a cash basis. As of December 31, 2011 and 2010, the Company had no past due loans and no loans on nonaccrual status, nor does the Company have any loans or commitments to lend funds to borrowers with loans whose terms have been modified in troubled debt restructurings.

## 5. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Furniture, fixtures and equipment | $ 1,266,000 | $ 962,000 |
| Leasehold improvements | 789,000 | 763,000 |
| | 2,055,000 | 1,725,000 |
| Less accumulated depreciation and amortization | (1,316,000) | (1,100,000) |
| | $ 739,000 | $ 625,000 |

Depreciation and amortization included in occupancy and equipment expense totaled $215,000 and $214,000 for the years ended December 31, 2011 and 2010, respectively.

## 6. INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

| | December 31, 2011 | December 31, 2010 |
|---|---|---|
| Savings | $ 151,000 | $ 97,000 |
| Money market | 48,884,000 | 29,357,000 |
| Interest-bearing demand accounts | 879,000 | 610,000 |
| Time, $100,000 or more | 6,819,000 | 7,196,000 |
| Other time | 884,000 | 1,271,000 |
| | $ 57,617,000 | $ 38,531,000 |

At December 31, 2011 all time deposits are scheduled to mature within twelve months.

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2011 and 2010 consisted of the following:

| | 2011 | 2010 |
|---|---|---|
| Savings and money market | $ 370,000 | $ 315,000 |
| Interest-bearing demand accounts | 1,000 | 1,000 |
| Time, $100,000 or more | 75,000 | 158,000 |
| Other time | 8,000 | 29,000 |
| | $ 454,000 | $ 503,000 |

## 7. INCOME TAXES

Income taxes for the years ended December 31, 2011 and 2010 consisted of the following:

| | Federal | State | Total |
|---|---|---|---|
| 2011 | | | |
| Current | $ 83,000 | $ 65,000 | $ 148,000 |
| Deferred | 179,000 | 35,000 | 214,000 |
| Income tax expense | $ 262,000 | $ 100,000 | $ 362,000 |

## 7. INCOME TAXES (Continued)

| | Federal | State | Total |
|---|---|---|---|
| 2010 | | | |
| Current | $ 272,000 | $ 115,000 | $ 387,000 |
| Deferred | (84,000) | (48,000) | (132,000) |
| Change in valuation allowance | (461,000) | (204,000) | (665,000) |
| Income tax benefit | $ (273,000) | $ (137,000) | $ (410,000) |

For the year ended December 31, 2011, the Company's reported amount of income tax expense differs from federal statutory rates primarily due to nondeductible merger expenses and California franchise taxes. For the year ended December 31, 2010, the Company's reported amount of income tax expense differs from federal statutory rates primarily due to the decrease in the valuation allowance on deferred tax assets.

Deferred tax assets (liabilities) at December 31, 2011 and 2010 consisted of the following:

| | 2011 | 2010 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 505,000 | $ 600,000 |
| Organization costs | 292,000 | 323,000 |
| Share-based compensation | 304,000 | 304,000 |
| Unrealized losses on available-for-sale investment securities reported in other comprehensive income | 873,000 | 135,000 |
| Unrealized losses on available-for-sale investment securities reported in net income | 54,000 | |
| Net operating losses | 46,000 | 46,000 |
| Other | 29,000 | 66,000 |
| Deferred tax assets | 2,103,000 | 1,474,000 |
| Deferred tax liabilities: | | |
| Future liability of state deferred tax asset | 111,000 | 123,000 |
| Cash to accrual basis | 81,000 | |
| Other | 58,000 | 22,000 |
| Total deferred tax liabilities | 250,000 | 145,000 |
| Net deferred tax assets | $ 1,853,000 | $ 1,329,000 |

## 7. INCOME TAXES (Continued)

The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed. Based upon its analysis of available evidence, management has determined that it is "more likely than not" that the Company's deferred income tax assets as of December 31, 2011 and 2010 will be fully realized and therefore no valuation allowance was recorded.

At December 31, 2011, the Company had no Federal net operating loss carryforwards and State net operating loss carryforwards (NOLs) of $422,000. The State NOLs begin to expire in 2017.

The Company files income tax returns in the United States and California jurisdictions. There are currently no pending Federal, state or local income tax examinations by tax authorities. Federal and California tax returns for 2008 to 2010 and 2007 to 2010, respectively, are currently open for examination. The total amount of unrecognized tax benefits, including interest and penalties, at December 31, 2011 was not material. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

## 8. BORROWING ARRANGEMENTS

The Company has unsecured Federal funds lines of credit with three of its correspondent banks under which it can borrow up to $10,000,000. There were no borrowings outstanding under these arrangements at December 31, 2011 and 2010.

The Company has a borrowing arrangement with the Federal Home Loan Bank of San Francisco under which it may borrow an amount not to exceed 20% of total assets. Various loans totaling approximately $27,644,000 were pledged to secure FHLB borrowings as of December 31, 2011. In addition, investment securities with amortized costs of $26,027,000 and estimated fair values of $25,798,000 were pledged to secure the borrowing arrangement as of December 31, 2011. The total borrowing capacity under these arrangements was $25,000,000 at December 31, 2011. Various loans totaling approximately $31,458,000 were pledged to secure FHLB borrowings as of December 31, 2010. In addition, investment securities with amortized costs of $3,860,000 and estimated fair values of $3,940,000 were pledged to secure the borrowing arrangement as of December 31, 2010. The total borrowing capacity under these arrangements was $15,961,000 at December 31, 2010.

## 8. BORROWING ARRANGEMENTS (Continued)

Advances under these arrangements were at fixed interest rates and consisted of the following at December 31, 2011 and 2010:

| | December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | |
| | Amount | Weighted Average Rate | Maturity Date | Amount | Weighted Average Rate | Maturity Date |
| Short-term borrowings | $ 7,000,000 | 0.13% | January 14, 2012 | $ 5,000,000 | 0.26% | January 18, 2011 |
| Long-term borrowings | 5,000,000 | 1.28% | January 21, 2014 | | | |
| | $12,000,000 | 0.61% | | $ 5,000,000 | 0.26% | |

## 9. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases its Santa Rosa headquarters and branch under a non-cancelable operating lease. The initial lease expires in June 2016 and has two five-year renewal options. The lease includes an annual rent adjustment of 3.5% each year during the initial lease term then adjusts to 95% of the fair market value of rents during the renewal periods. The Company leases its Rancho Cucamonga branch under a non-cancelable operating lease. The initial lease expires in August 2016 and has one five-year renewal option. The lease includes rent adjustments of 2.7% and 2.6% in August of 2013 and 2015, respectfully.

Future minimum lease payments are as follows:

| Year Ending December 31, | Operating Leases |
|---|---|
| 2012 | $ 367,000 |
| 2013 | 378,000 |
| 2014 | 389,000 |
| 2015 | 401,000 |
| 2016 | 205,000 |
| | $ 1,740,000 |

Rental expense included in occupancy and equipment expense totaled $295,000 and $250,000 for the years ended December 31, 2011 and 2010 respectively. Management intends to exercise the renewal options described above and expects additional future minimum lease payments as a result of exercising the renewal options will be approximately $198,000 in 2016 and $3,429,000 thereafter.

## 9. COMMITMENTS AND CONTINGENCIES (Continued)

Financial Instruments With Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit totaling $26,657,000 and $19,093,000 at December 31, 2011 and 2010, respectively.

The Company's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for loans included on the balance sheet.

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 some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, and deeds of trust on residential real estate and income-producing commercial properties.

At December 31, 2011 commercial loan commitments represent approximately 49% of total commitments and are generally unsecured or secured by collateral other than real estate and have variable interest rates. Real estate loan commitments represent approximately 39% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 80%. The majority of real estate commitments also have variable interest rates. Home equity lines of credit represent 12% of total commitments and are generally secured by residential real estate and have both variable and fixed interest rates.

Concentrations of Credit Risk

The Company grants real estate mortgage, real estate construction and commercial loans to customers throughout the counties of Sonoma, Marin, San Francisco, San Bernardino and Los Angeles. Although management intends to continue to diversify the Company's loan portfolio, a substantial portion of the portfolio is secured by commercial and residential real estate at December 31, 2011 and 2010.

In management's judgment, a concentration of loans exists in real estate related loans with approximately 84% of the Company's loans being real estate related. Although management believes the loans within this concentration have no more than the normal risk of collectibility, a substantial decline in the performance of the economy in general or a decline in real estate values in the Company's primary market area, in particular, could have an adverse impact on the collectibility of these loans. Personal and business income represent the primary source of repayment for a majority of these loans.

## 9. COMMITMENTS AND CONTINGENCIES (Continued)

Correspondent Companying Agreements (Continued)

The Company maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. Through December 31, 2012, all noninterest-bearing transaction accounts are fully guaranteed by the FDIC for the entire amount in the account. Coverage through December 31, 2012 on certain transaction accounts is in addition to the coverage of $250,000 per depositor available under the FDIC's general deposit insurance rules.

## 10. SHARE-BASED COMPENSATION

Stock Option Awards

A summary of option activity under the Plan for the years ended December 31, 2011 and 2010 is presented below:

| | Number of Stock Options | Weighted Average Exercise Prices | Weighted Average Remaining Contractual Life | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2010 | 543,206 | $ 8.57 | 6.8 years | |
| Outstanding at December 31, 2010 | 543,206 | $ 8.57 | 5.8 years | |
| Granted | 26,407 | $ 7.88 | | |
| Forfeited | (867) | $ 8.60 | | |
| Outstanding at December 31, 2011 | 568,746 | $ 8.52 | 5.0 years | |
| Exercisable at December 31, 2011 | 523,355 | $ 8.58 | 5.0 years | $ 250,000 |
| Options expected to vest | 45,125 | $ 7.8 | 8.8 years | $ 56,000 |

As of December 31, 2011, the unrecognized share-based compensation expense related to non-vested stock option awards totaled $143,000. That cost is expected to be amortized on a straight-line basis over a weighted average period of 2.9 years and will be adjusted for subsequent changes in estimated forfeitures. Total compensation cost included in operating expenses was $42,000 and $201,000 for the years ended December 31, 2011 and 2010, respectively. The fair value of options vested during the year was $359,000 and $342,000 for the years ended December 31, 2011 and 2010, respectively.

## 10. SHARE-BASED COMPENSATION (Continued)

Stock Option Awards (Continued)

No stock options were granted during 2010. The following stock option information is for the year ended December 31, 2011:

| | 2011 |
|---|---|
| Weighted average grant date fair value per share of options | $4.34 |
| Significant weighted average assumptions: | |
| Expected term in years | 6.5 years |
| Expected annual volatility | 55.9% |
| Expected annual dividend yield | 0.0% |
| Risk-free interest rate | 2.1% |

## 11. SHAREHOLDERS' EQUITY

Cash Dividends

Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total cash dividend payment of any state banking association in any calendar year to the lesser of (1) the bank's retained earnings or (2) the bank's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period. At December 31, 2011, no amounts were free of such restrictions.

Stock Dividends

On February 3, 2010, the Board of Directors declared a five percent stock dividend which was paid on February 26, 2010 to shareholders of record as of February 12, 2010. On October 1, 2010, the Board of Directors declared a five percent stock dividend which was paid on February 18, 2011 to shareholders of record as of February 4, 2011. On March 7, 2012 the Board of Directors declared a five percent stock dividend which is payable on April 20, 2012 to shareholders of record as of April 6, 2012. These stock dividends were accounted for in a manner similar to a stock split because the Company has an accumulated deficit. As such, all share and per share amounts have been restated to give retroactive effect to these five percent stock dividends.

## 11. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital

The Company and Bank are subject to certain regulatory capital requirements administered by the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC). Failure to meet these minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. As a small bank holding company, the Company is not subject to specific regulatory capital requirements. The risk-based capital guidelines described below apply on a consolidated basis to bank holding companies with consolidated assets of $500 million or more. For bank holding companies with less than $500 million in consolidated assets, the guidelines will be applied on a bank-only basis unless: (a) the parent bank holding company is engaged in nonbank activity involving significant leverage; or (b) the parent company has a significant amount of outstanding debt that is held by the general public. Because neither (a) nor (b) apply to the Company, regulators look to the Bank's capital ratios when assessing the adequacy of the Company's capital.

Under capital adequacy guidelines, 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. These quantitative measures are established by regulation and require that minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets be maintained as set forth in the table below. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Management believes the Company and Bank met all of their capital adequacy requirements as of December 31, 2011 and 2010.

The Bank is also subject to additional capital guidelines under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum ratios of total and Tier 1 capital to risk-weighted assets and Tier 1 capital to average assets as set forth in the table on the following page. The most recent notification from the FRB categorized the Bank as well capitalized under these guidelines. There are no conditions or events since that notification that management believes have changed the Bank's category.

## 11. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital (Continued)

The Bank's actual capital amounts and notations of December 31, 2011 and 2010 are as follows:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio |
| Tier 1 Capital to Average Assets | | | | |
| AltaPacific Bank | $ 27,272,000 | 23.4% | $ 26,643,000 | 34.0% |
| Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions | $ 5,815,000 | 5.0% | $ 3,918,000 | 5.0% |
| Minimum required for capital adequacy purposes | $ 4,652,000 | 4.0% | $ 3,135,000 | 4.0% |
| Tier 1 Risk-Based Capital to Risk-Weighted Assets | | | | |
| AltaPacific Bank | $ 27,272,000 | 28.2% | $ 26,643,000 | 37.4% |
| Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions | $ 5,809,000 | 6.0% | $ 4,271,000 | 6.0% |
| Minimum required for capital adequacy purposes | $ 3,873,000 | 4.0% | $ 2,847,000 | 4.0% |
| Total Risk-Based Capital to Risk Weighted Assets | | | | |
| AltaPacific Bank | $ 28,479,000 | 29.4% | $ 27,539,000 | 38.7% |
| Minimum requirement for "Well-Capitalized" institution under prompt corrective action provisions | $ 11,629,000 | 10.0% | $ 7,118,000 | 10.0% |
| Minimum required for capital adequacy purposes | $ 9,303,000 | 8.0% | $ 5,694,000 | 8.0% |

## 12. EMPLOYEE BENEFIT PLANS

Profit Sharing Plan

In 2006, the Company adopted a 401(k) Plan (the "Plan") covering substantially all employees 21 years of age or older with 3 months of service. Eligible employees may elect to make tax deferred contributions up to the maximum amount allowed by law. The Plan is a Safe Harbor Plan and currently matches employee contributions up to 4% of compensation. In addition, the Company may make an annual discretionary profit-sharing contribution. Employee contributions, Company matching contributions and related earnings are always 100% vested. Company profit-sharing contributions and related earnings vest 20% a year, with 100% vesting after five years of service. The Company's expense for matching contributions was $66,000 and $51,000 for the years ended December 31, 2011 and 2010, respectively. The Company did not make a discretionary profit-sharing contribution for the years ended December 31, 2011 or 2010.

## 13. OTHER EXPENSES

Other expenses for the years ended December 31, 2011 and 2010 consisted of the following:

| | 2011 | 2010 |
|---|---|---|
| Data processing | $ 340,000 | $ 325,000 |
| Professional fees | 353,000 | 173,000 |
| Regulatory assessments | 122,000 | 120,000 |
| OREO | 63,000 | 26,000 |
| Correspondent banking fees | 44,000 | 42,000 |
| Director fees | 42,000 | 21,000 |
| Stationery and supplies | 39,000 | 48,000 |
| Telephone | 37,000 | 20,000 |
| Advertising and marketing | 36,000 | 30,000 |
| Insurance | 29,000 | 30,000 |
| Travel | 26,000 | 17,000 |
| Shareholder services | 12,000 | 12,000 |
| Share-based expense – Directors | | 82,000 |
| Other | 163,000 | 133,000 |
| | $ 1,306,000 | $ 1,079,000 |

## 14. FAIR VALUE MEASUREMENTS

Fair Value of Financial Instruments

The estimated carrying fair values of the Company's financial instruments are as follows:

| | December 31, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets: | | | | |
| Cash and due from banks | $ 2,055,000 | $ 2,055,000 | $ 790,000 | $ 790,000 |
| Federal funds sold | 2,005,000 | 2,005,000 | 1,510,000 | 1,510,000 |
| Interest-bearing deposits in banks | 249,000 | 249,000 | 3,287,000 | 3,287,000 |
| Available-for-sale investment securities | 41,548,000 | 41,548,000 | 9,645,000 | 9,645,000 |
| Loans, net | 58,574,000 | 58,935,000 | 60,132,000 | 60,321,000 |
| Federal Reserve Bank stock | 806,000 | N/A | 775,000 | N/A |
| Federal Home Loan Bank stock | 564,000 | N/A | 379,000 | N/A |
| Accrued interest receivable | 562,000 | 562,000 | 282,000 | 282,000 |
| Financial liabilities: | | | | |
| Deposits | $ 76,400,000 | $ 76,384,000 | $ 47,139,000 | $ 47,315,000 |
| Other borrowings | 12,000,000 | 12,000,000 | 5,000,000 | 5,000,000 |
| Accrued interest payable | 13,000 | 13,000 | 14,000 | 14,000 |

## 14. FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments (Continued)

These estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

The following methods and assumptions were used to estimate the fair value of financial instruments. For cash and due from banks, interest-bearing deposits in banks, Federal funds sold, variable-rate loans, accrued interest receivable and payable, demand deposits and short-term borrowings, the carrying amount is estimated to be fair value. For investment securities, fair values are based on quoted market prices, quoted market prices for similar securities and indications of value provided by brokers. It was not practicable to determine the fair value of FRB stock and FHLB stock due to restrictions placed on their transferability. The fair values for fixed-rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flow analyses using interest rates offered at each reporting date by the Company for certificates with similar remaining maturities. The fair value of long-term borrowings is estimated using discounted cash flow analysis using rates on borrowing arrangements available to the Company at the balance sheet date with similar remaining maturities. The fair values of commitments are estimated using the fees currently charged to enter into similar agreements and are not significant and, therefore, not included in the above table.

Fair Value Hierarchy

The Company groups its assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Valuations within these levels are based upon:

Level 1 – Quoted market prices for identical instruments traded in active exchange markets.

Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3 – Model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Company's estimates of assumptions that market participants would use on pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

## 14. FAIR VALUE MEASUREMENTS (Continued)

Fair Value Hierarchy (Continued)

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Assets Recorded at Fair Value

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring and nonrecurring basis:

*Recurring Basis*

| Description | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| December 31, 2011 | | | | |
| Available-for-sale investment securities: | | | | |
| Corporate securities | $ 9,590,000 | | $ 9,590,000 | |
| Mortgage-backed securities- residential: | | | | |
| Agency | 25,798,000 | | 25,798,000 | |
| Non-agency | 6,160,000 | | 6,160,000 | |
| Total assets measured at fair value on a recurring basis | $ 41,548,000 | $ - | $ 41,548,000 | $ - |
| December 31, 2010 | | | | |
| Available-for-sale investment securities: | | | | |
| Mortgage-backed securities- residential: | | | | |
| Agency | $ 2,979,000 | | $ 2,979,000 | |
| Non-agency | 6,666,000 | | 6,666,000 | |
| Total assets measured at fair value on a recurring basis | $ 9,645,000 | $ - | $ 9,645,000 | $ - |

Fair values for corporate securities and agency and non-agency residential mortgage-backed securities are based on quoted market prices for similar securities. During the year ended December 31, 2011 and 2010, there were no significant transfers in or out of Levels 1 and 2 or changes in the valuation techniques used.

## 14. FAIR VALUE MEASUREMENTS (Continued)

Assets Recorded at Fair Value (Continued)

*Non-recurring Basis*

The Company may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date.

| Description | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| December 31, 2011 | | | | |
| Other real estate owned | $ 766,000 | $ - | $ - | $ 766,000 |
| December 31, 2010 | | | | |
| Other real estate owned | $ 781,000 | $ - | $ - | $ 781,000 |

Other real estate owned – The fair value of other real estate owned is based on the fair value of the property less estimated costs to sell. If the Company determines that the fair value of other real estate owned is less than its carrying value it is adjusted through impairment expense charged to noninterest expenses. There were no losses recognized for write-down of other real estate owned for the year ended December 31, 2011 and 2010. However, losses totaling $613,000 were recognized as impairment charge during the year ended December 31, 2010 for the period of time this property was collateral for a loan that was considered impaired. These losses were recorded as charge-offs to the allowance for loan losses prior to the property being acquired through foreclosure.

The Company had no liabilities measured at fair value on a recurring or non–recurring basis at December 31, 2011 and 2010.

## 15. SUBSEQUENT EVENT

Effective February 18, 2012, the Company acquired 100 percent of Stellar Business Bank pursuant to an Agreement and Plan of Reorganization (the "Agreement") dated September 14, 2011. The acquisition was accomplished by the merger of Stellar Business Bank into AltaPacific Bank. Stellar Business Bank operated a branch in Covina, California. Under terms of the Agreement, Stellar Business Bank's shareholders received .8443 shares of the Company's common stock for each share of the common stock of Stellar Business Bank.

**15. SUBSEQUENT EVENT** (Continued)

The primary reasons for the merger are to expand the Company's presence in southern California, grow and diversify its asset base, improve earnings opportunities and increase liquidity for the Company's stock. The Company will account for the acquisition of Stellar Business Bank under the acquisition method. Under the acquisition method, the assets acquired, liabilities assumed and equity interests issued will be recorded at fair value at the date of acquisition. It is not practical to present pro forma revenue and earnings for the combined company at this time because the fair value information on the assets acquired and liabilities assumed from Stellar Business Bank has not been finalized.

Under the terms of the merger agreement, the Company issued approximately 1,938,000 shares of its common stock to the shareholders of Stellar Business Bank. In connection with the closing of the merger the Company paid approximately $48,000 to persons who held in-the-money options to purchase Stellar Business Bank common stock (all of which rights were cancelled at the effective time and were not assumed by the Company).