

**SUNWEST BANK AND SUBSIDIARIES**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**WITH**  
**INDEPENDENT AUDITORS' REPORT**

**December 31, 2008 and 2007**

SUNWEST BANK AND SUBSIDIARIES  
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Vavrinek, Trine, Day & Co., LLP  
Certified Public Accountants & Consultants

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## INDEPENDENT AUDITORS' REPORT

Board of Directors and Shareholders of  
Sunwest Bank and Subsidiaries

We have audited the accompanying consolidated statements of financial condition of Sunwest Bank and Subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows of the years then ended. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated 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 audits provide 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 Sunwest Bank and Subsidiaries as of December 31, 2008 and 2007, 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.

*Vavrinek, Trine, Day & Co., LLP*

Laguna Hills, California  
March 25, 2009

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**SUNWEST BANK AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
(Dollars in thousands)

	December 31, 2008	December 31, 2007
<b>ASSETS</b>		
Cash and due from banks .....	\$ 22,570	\$ 10,781
Fed funds sold, mutual funds and interest-bearing deposits.....	250	36,247
Total cash and cash equivalents .....	22,820	47,028
Securities, available for sale (“AFS”), at fair value .....	119,949	91,958
Loans, net of deferred fees .....	158,992	149,604
Allowance for loan losses .....	(2,171)	(2,438)
Net loans .....	156,821	147,166
Investment in Federal Home Loan Bank (“FHLB”) stock .....	2,276	1,164
Premises and equipment, net .....	307	638
Bank owned life insurance.....	9,711	9,255
Other assets .....	2,727	2,139
Total Assets.....	\$ 314,611	\$ 299,348
<b>LIABILITIES AND SHAREHOLDERS’ EQUITY</b>		
Liabilities:		
Demand deposits .....	\$ 107,461	\$ 146,987
Money market and savings accounts.....	114,095	89,278
Time deposits .....	10,915	16,072
Total deposits .....	232,471	252,337
FHLB advances.....	40,375	5,375
Accounts payable and other liabilities.....	2,735	3,365
Total Liabilities .....	275,581	261,077
Commitments and contingencies.....	-	-
Shareholders’ Equity		
Preferred stock, no par value: 5,000,000 shares authorized, no shares issued and outstanding at December 31, 2008 or December 31, 2007...	-	-
Common stock, no par value: 30,000,000 shares authorized, 17,142 and 17,161 shares issued and outstanding at December 31, 2008 and December 31, 2007, respectively .....	27,788	27,709
Retained earnings since November 30, 2002 .....	10,705	9,946
Accumulated other comprehensive income, net of tax.....	537	616
Total Shareholders’ Equity.....	39,030	38,271
Total Liabilities and Shareholders’ Equity.....	\$ 314,611	\$ 299,348

See Notes to Consolidated Financial Statements

**SUNWEST BANK AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Dollars in thousands, except per share amounts)

	Year Ended December 31,	
	2008	2007
Interest income		
Loans .....	\$ 10,595	\$ 11,646
Securities, AFS .....	6,047	3,922
Fed funds sold, mutual funds and interest-bearing deposits .....	561	2,991
Total interest income .....	17,203	18,559
Interest expense		
Deposits .....	2,077	2,603
Borrowings .....	1,138	239
Total interest expense .....	3,215	2,842
Net interest income .....	13,988	15,717
Provision for loan losses .....	192	-
Net interest income after provision for loan losses .....	13,796	15,717
Noninterest income:		
Deposit charges .....	554	510
Net (loss) gain from sales and write-downs of securities .....	(2,975)	124
Other income .....	469	435
Total noninterest income .....	(1,952)	1,069
Noninterest expense:		
Compensation and benefits .....	6,189	5,996
Occupancy and depreciation .....	1,891	1,973
Customer service .....	471	2,734
Professional services .....	864	907
Other expenses .....	2,108	2,236
Total noninterest expense .....	11,523	13,846
Income before taxes .....	321	2,940
Income taxes .....	(443)	651
Net income .....	\$ 764	\$ 2,289
Net income per share:		
Basic .....	\$ 44.57	\$ 132.80
Diluted .....	44.52	132.36
Shares used to compute:		
Basic net income per share .....	17,143	17,237
Diluted net income per share .....	17,162	17,294

See Notes to Consolidated Financial Statements

SUNWEST BANK AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Dollars in thousands)

	Year Ended December 31,	
	2008	2007
Net income .....	\$ 764	\$ 2,289
Other comprehensive income, net of tax:		
Reclassification adjustment for realized losses and (gains) on AFS securities, net of \$1,220 and (\$17) respectively, of income taxes.....	1,751	(24)
Unrealized (loss) gain on AFS securities arising during year, net of (\$1,279) and \$328, respectively, of income taxes.....	(1,830)	470
Total other comprehensive income, net of tax .....	(79)	446
Comprehensive income .....	\$ 686	\$ 2,735

See Notes to Consolidated Financial Statements

**SUNWEST BANK AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars in thousands)

	Common Stock		Retained Earnings	Accumulated Other Comprehensive	Shareholders' Equity
	Shares	Amount		Income (Loss)	
Balance, January 1, 2007 .....	17,263	\$ 27,739	\$ 7,745	\$ 170	\$ 35,654
Net income .....	-	-	2,289	-	2,289
Other comprehensive income, net of tax .....	-	-	-	446	446
Stock-based compensation .....	-	130	-	-	130
Common stock issued .....	2	4	-	-	4
Common stock retired .....	(104)	(164)	(88)	-	(252)
Balance, December 31, 2007 ....	17,161	27,709	9,946	616	38,271
Net income .....	-	-	764	-	764
Other comprehensive income, net of tax .....	-	-	-	(79)	(79)
Stock-based compensation .....	-	110	-	-	110
Common stock retired .....	(19)	(31)	(5)	-	(36)
Balance, December 31, 2008 ....	17,142	\$ 27,788	\$ 10,705	\$ 537	\$ 39,030

See Notes to Consolidated Financial Statements

**SUNWEST BANK AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Dollars in thousands)

	Year Ended December 31,	
	2008	2007
<b><u>Cash Flows from Operating Activities</u></b>		
Net income.....	\$ 764	\$ 2,289
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization .....	331	388
Provision for credit losses .....	192	-
Income accreted on bank-owned life insurance .....	(456)	(423)
Deferred income taxes.....	(1,094)	146
Net gain on sales of securities .....	(163)	(124)
Write-down of securities .....	3,138	-
Amortization and accretion of AFS securities.....	101	48
Dividends of FHLB Stock.....	(103)	(59)
Stock-based compensation expense.....	110	130
Decrease (increase) in other assets .....	506	(260)
(Decrease) increase in other liabilities.....	(452)	87
Net cash provided by operating activities .....	<u>2,874</u>	<u>2,222</u>
<b><u>Cash Flows from Investing Activities</u></b>		
Proceeds from maturities and repayments of securities.....	17,358	6,543
Purchases of AFS securities .....	(73,560)	(41,496)
Proceeds from sale of securities AFS.....	25,001	8,171
Purchase of Federal Home Loan Bank stock.....	(1,009)	-
Net increase in loans.....	(9,847)	(11,316)
Purchases of premises and equipment .....	-	(10)
Net cash used in investing activities .....	<u>(42,057)</u>	<u>(38,108)</u>
<b><u>Cash Flows from Financing Activities</u></b>		
Decrease in deposits .....	(19,866)	(4,535)
Increase in FHLB advances, net .....	35,000	-
Common stock repurchased.....	(36)	(252)
Payments for fractional shares relating to 2004 stock split.....	(123)	(113)
Common stock options exercised .....	-	4
Net cash provided (used in) by financing activities .....	<u>14,975</u>	<u>(4,896)</u>
Decrease in cash and cash equivalents .....	(24,208 )	(40,782 )
Cash and cash equivalents at beginning of year .....	47,028	87,810
Cash and cash equivalents at end of year .....	<u>\$ 22,820</u>	<u>\$ 47,028</u>
<b><u>Supplemental disclosures of cash flow information:</u></b>		
Cash paid during the period for:		
Interest.....	\$ 2,939	\$ 2,820
Income taxes, net.....	642	332

See Notes to Consolidated Financial Statements

## ***NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES***

### ***BUSINESS***

Sunwest Bank (the “Bank”) commenced operations as a California state-chartered bank in 1970 and currently operates primarily in Orange County, California. The Bank has three (3) wholly owned subsidiaries, Sunwest Leasing Corp and North Orange County Bancorp, which are inactive and WCV, Inc., which, holds real property acquired by the Bank upon foreclosures with a carrying value of zero.

The Bank presently has four banking offices within Orange County, California. The main office is located in Tustin, California at 17542 East 17th Street, Suite 200 Tustin, California 92780. The Bank’s other branch offices are located in Newport Beach, Anaheim and Laguna Hills, California.

Through its network of banking offices, the Bank emphasizes personalized service combined with services primarily directed to small and medium sized businesses and professionals. Although the Bank focuses its marketing of services to businesses and professionals, a wide range of consumer banking services are made available to its customers.

The Bank offers a wide range of deposit instruments. These include personal and business checking and savings accounts, including interest-bearing negotiable order of withdrawal (“NOW”) accounts, Super NOW accounts, money market accounts, time certificates of deposit (“CD”) accounts and individual retirement accounts (“IRA”).

The Bank also engages in a full complement of lending activities, including commercial, consumer installment, and real estate loans. Commercial loans are loans to local community businesses and may be unsecured or secured by assets of the business and/or its principals. Consumer installment loans include loans for automobiles, home improvements, debt consolidation and other personal needs. Real estate loans include secured short-term permanent real estate loans and construction loans. In addition, the Bank originates loans that are guaranteed under the Small Business Investments Act. The Bank currently retains SBA loans in its portfolio.

The Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include ATMs, ACH originations, on-line banking, touch-tone federal and state tax payment processing, lockbox services, travelers’ checks, safe deposit, MasterCard and Visa merchant credit card services, ATM cards, Visa debit cards, business sweep accounts and remote deposit capture services.

During its business cycle, the Bank is subject to economic and regulatory risk. Economic risk is comprised of: 1) Interest rate risk - the risk created when the Bank’s interest bearing liabilities reprice and mature at different time intervals than its interest bearing assets; 2) Credit risk - the risk created from the Bank’s borrower’s inability or unwillingness to repay their debts; and 3) Market risk - the risk associated with changes in the value of real estate maintained as collateral for outstanding debt.

The Bank is subject to continued examination by the Federal Deposit Insurance Corporation and the California Department of Financial Institutions. Regulations imposed by these and other agencies can and do change significantly from time to time. These regulations may alter the way the Bank delivers its banking products and also restrict the Bank from offering certain services.

At December 31, 2008, the Bank employed 77 full-time equivalent employees.

## *BASIS OF PRESENTATION*

The consolidated financial statements include the accounts of the Bank and its wholly owned subsidiaries, Sunwest Leasing Corp, North Orange County Bancorp and WCV, Inc. All inter-company balances and transactions have been eliminated in consolidation.

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates.

## *CASH AND CASH EQUIVALENTS*

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks, investment securities with original maturities of less than ninety days, money market mutual funds and Federal funds sold.

The Bank is required to maintain non-interest-bearing cash reserves at the Federal Reserve Bank of San Francisco. At December 31, 2008, the Bank did not have a reserve requirement. Reserves totaling \$0.4 million were required by the Bank for the period ending December 31, 2007.

At times, the Bank maintains cash at major financial institutions in excess of FDIC insured limits. However, as the Bank places these deposits with major well-capitalized financial institutions and monitors the financial condition of these institutions, management believes the risk of loss to be minimal.

## *MUTUAL FUNDS*

The Bank's money market mutual fund investments are included in cash and cash equivalents. Excess liquidity may be invested in money market mutual funds. Interest income from mutual funds is recorded on a monthly basis.

## *INVESTMENT SECURITIES*

Investment securities for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity.

Investments not classified as trading securities nor as held to maturity securities are classified as available-for-sale securities and recorded at fair value. Unrealized gains or losses on available-for-sale securities are excluded from net income and reported as an amount net of taxes as a separate component of other comprehensive income included in shareholders' equity. Premiums or discounts on held-to-maturity and available-for-sale securities are amortized or accreted into income using the interest method. Realized gains or losses on sales of held-to-maturity or available-for-sale securities are recorded using the specific identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other-than-temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers; the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and 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.

## *FAIR VALUE MEASUREMENT*

Effective January 1, 2008, the Bank adopted SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. Statement 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Statement 157 also establishes a fair value hierarchy. The three levels of fair value hierarchy are (1) quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date, (2) significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data, and (3) significant unobservable inputs that reflect a Bank's own assumptions about the assumptions that market participants would use in pricing an asset or liability. The impact of adoption of SFAS No. 157 is not material.

In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) for fiscal years beginning after November 15, 2008.

In February 2007, the FASB issued Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard was effective for the Bank on January 1, 2008. The Bank did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

## *FEDERAL HOME LOAN BANK STOCK*

As a member of the Federal Home Loan Bank (FHLB), the Bank is required to purchase FHLB stock in accordance with its advances, securities and deposit agreement. The stock is substantially restricted and may be redeemed at par value, however only in connection with the Bank surrendering its FHLB membership. This investment is carried at cost plus accumulated stock dividends as of December 31, 2008 and 2007.

## *LOANS*

Loans are generally recorded in the financial statements at the principal amount outstanding, net of deferred loan fees, unearned income and the allowance for loan losses. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Accrual of interest on loans is discontinued when reasonable doubt exists as to the full, timely collection of interest or principal and, generally, when a loan becomes contractually past due for ninety days or more with respect to principal or interest. The accrual of interest may be continued on a well-secured loan contractually past due ninety days or more with respect to principal or interest if the loan is in the process of collection or collection of the principal and interest is deemed probable.

When a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period income. Interest on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Accrual of interest is resumed on loans only when, in the judgment of management, the loan is estimated to be fully collectible.

The Bank evaluates its loans on a regular basis for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Generally, loans that the Bank has classified as nonaccrual, are considered impaired, although a nonaccrual classification does not necessarily imply that a loan valuation deficiency exists.

The measurement of impairment may be based on (1) the present value of the expected future cash flows discounted at the loan's effective interest rate, (2) the observable market price of the loan, or (3) the fair value of the collateral if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Bank recognizes the impairment, by creating a valuation allowance with a corresponding charge to bad debt expense. Impairment measurement also applies to restructured loans and in-substance foreclosures (loans where the creditor has received physical possession of the borrower's assets). A collateralized loan considered an in-substance foreclosure is classified as other real estate owned even if formal foreclosure proceedings have not taken place.

The Bank continues to accrue interest on restructured loans since full payment of principal and interest is expected and such loans are performing or less than ninety days delinquent and therefore do not meet the criteria for nonaccrual status. Restructured loans that have been placed on non-accrual status are returned to accrual status when the remaining loan balance, net of any charge-offs related to the restructure, is estimated to be fully collectible by management and performing in accordance with the applicable loan terms.

### *LOAN ORIGINATION FEES AND COSTS*

Net loan origination fees and direct costs associated with lending are deferred and amortized to interest income as an adjustment to yield over the respective lives of the loans using the interest method. The amortization of deferred fees and costs is discontinued on loans that are placed on nonaccrual status. When a loan is paid off, any unamortized net loan origination fees are recognized in interest income.

### *ALLOWANCE FOR LOAN LOSSES*

The allowance for estimated losses on loans is established by charges against earnings and is maintained at a level considered necessary by management to meet identified and inherent losses in the portfolio. The adequacy of the allowance for loan losses is based on management's evaluation of the factors underlying the quality of the loan portfolio, including current and anticipated economic conditions, past loan loss experience, assessment of geographic lending areas and detailed analysis of individual loans for which full recovery may not be assured. The allowance for loan losses is increased by charges or provisions against income and is reduced by loan charge-offs, net of recoveries. While management believes that the allowance for loan losses is adequate, future additions to the allowance may be necessary based on changes in circumstances and economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgements about information available to them at the time of their examination.

### *OTHER REAL ESTATE OWNED*

Other real estate owned (OREO) represents the collateral acquired through foreclosure in full or partial satisfaction of the related loan. OREO is recorded at the fair value less estimated selling costs at the date of foreclosure. Any write-down at the date of transfer is charged to the allowance for loan losses. The recognition of gains or losses on sales of OREO is dependent upon various factors relating to the nature of the property being sold and the terms of sale. OREO values are reviewed on an ongoing basis and any decline in value is recognized as foreclosed asset expense in the current period. The net operating results from these assets are included in the current period in noninterest expense as foreclosed asset expense (income). The Bank owned one OREO property, which had no carrying value in the consolidated financial statements of the Bank, as of December 31, 2008.

### *PREMISES AND EQUIPMENT*

Premises and equipment are stated at cost, less accumulated depreciation and amortization, which is charged to expense on a straight-line basis over the estimated useful lives of 3 to 10 years. Premises under leasehold improvements are amortized on a straight-line basis over the term of the lease or the estimated useful life of the improvements whichever is shorter. Expenditures for major renewals and betterments of premises and equipment are capitalized and those for maintenance and repairs are charged to expense as incurred. A valuation allowance is

established for any impaired long-lived assets. The Bank did not have impaired long-lived assets as of December 31, 2008 or 2007.

### INCOME TAXES

The Bank accounts for income taxes using the asset and liability method. Under the asset and liability method, 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. A valuation allowance is established if it is “more likely than not” that all or a portion of the deferred tax asset will not be realized.

The Bank has adopted Financial Accounting Standards Interpretation No. 48 (“Fin 48”), *Accounting for Uncertainty in Income Taxes*. Fin 48 clarifies the accounting for uncertainty in tax positions taken or expected to be taken on a tax return and provides that the tax effects from an uncertain tax position can be recognized in the financial statements only if, based on its merits, the position is more likely than not to be sustained on audit by the taxing authorities. Management believes that all tax positions taken to date are highly certain and, accordingly, no accounting adjustment has been made to the financial statements. Interest and penalties related to uncertain tax positions are recorded as part of income tax expense.

### STOCK BASED COMPENSATION

The Bank has adopted SFAS No. 123(R) “*Share-Based Payment*.” This Statement generally requires entities to recognize the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period, which an employee is required to provide services in exchange for the award, generally the vesting period.

### EARNINGS PER SHARE (“EPS”)

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate solely to outstanding stock options, and are determined using the treasury stock method.

The following is a reconciliation of basic EPS to diluted EPS for the years ended December 31 (dollars in thousands, except per share amounts):

	2008	2007
Net income.....	\$ 764	\$ 2,289
Weighted average number of common shares outstanding:		
Basic .....	17,143	17,237
Dilutive effect of restrictive stock grants .....	11	33
Dilutive effect of common stock equivalents: stock options...	8	24
Dilutive .....	17,162	17,294
Net income per share:		
Basic.....	\$ 44.57	\$ 132.80
Diluted.....	44.52	132.36

The Bank has 831 stock options outstanding that could potentially dilute EPS in future periods that were excluded from the above computations because the impact of including them was antidilutive.

## RECLASSIFICATIONS

Certain amounts in the 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation.

## NOTE 2: INVESTMENT SECURITIES

The following tables provide a summary of the Bank's available for sale investment portfolio as of the dates indicated (dollars in thousands):

<u>As of December 31, 2008</u>	Amortized Cost	Gross Unrealized		Estimated Fair Value
		Gains	Losses	
US Treasury securities .....	\$ 14,925	\$ 1,645	\$ -	\$ 16,570
Tax-free municipal bonds .....	25,060	494	(227)	25,327
Collateralized debt obligations .....	2,847	-	(1,566)	1,281
Collateralized mortgage obligations .....	2,861	19	-	2,880
Mortgage backed securities .....	66,517	1,449	(53)	67,913
Taxable municipal bonds .....	192	5	-	197
Corporate bonds .....	5,634	-	(903)	4,731
Trust preferred securities .....	1,000	50	-	1,050
Total .....	<u>\$ 119,036</u>	<u>\$ 3,662</u>	<u>\$ (2,749)</u>	<u>\$ 119,949</u>

<u>As of December 31, 2007</u>	Amortized Cost	Gross Unrealized		Estimated Fair Value
		Gains	Losses	
US Treasury securities .....	\$ 32,792	\$ 1,232	\$ -	\$ 34,024
Tax-free municipal bonds .....	25,532	176	(195)	25,513
Collateralized debt obligations .....	4,000	-	-	4,000
Collateralized mortgage obligations .....	3,421	8	(85)	3,344
Mortgage backed securities .....	15,462	126	-	15,588
Taxable municipal bonds .....	1,144	24	-	1,168
Corporate bonds .....	7,560	-	(239)	7,321
Trust preferred securities .....	1,000	-	-	1,000
Total .....	<u>\$ 90,911</u>	<u>\$ 1,566</u>	<u>\$ (519)</u>	<u>\$ 91,958</u>

At December 31, 2008 and 2007, investment securities available-for-sale with a market value of \$58.8 million and \$24.9 million respectively, were pledged as collateral to secure public funds and for other purposes as required or permitted by law.

Proceeds from sales of investment securities during 2008 and 2007 were \$25.0 million and \$8.2 million, which resulted in net realized gains of \$163,000 and \$124,000, respectively.

In 2008, the Bank wrote-down the carrying value of certain collateralized debt obligation securities whose fair market value deficiency was deemed other than temporary and recorded a pre-tax loss totaling \$3.1 million. Refer to Note 11 for more information regarding fair market value measurement.

The amortized cost and estimated fair value of securities at December 31, 2008, by contractual maturity, are shown below. Mortgage-backed securities and collateralized mortgage obligations are classified in accordance with their estimated lives. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations. Trust preferred securities are classified in excess of ten years (dollars in thousands).

	Amortized Cost	Estimated Fair Value
Within one year .....	\$ 28,179	\$ 27,260
After one year through five years .....	67,325	69,829
After five years through ten years .....	12,869	13,008
After ten years .....	10,663	9,852
Total .....	<u>\$ 119,036</u>	<u>\$ 119,949</u>

The following is a summary of investment securities that have unrealized losses as of the dates indicated (dollars in thousands):

	Less than 12 months		12 months or More	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
<i>As of December 31, 2008</i>				
Tax-free municipal bonds .....	\$ 726	\$ (54)	\$ 6,054	\$ (173)
Mortgage backed Securities .....	1,278	(53)	-	-
Collateralized debt obligations .....	1,281	(1,566)	-	-
Corporate bonds .....	-	-	4,731	(903)
Total .....	<u>\$ 3,285</u>	<u>\$ (1,673)</u>	<u>\$ 10,785</u>	<u>\$ (1,076)</u>
<i>As of December 31, 2007</i>				
Tax-free municipal bonds .....	\$ 8,662	\$ (121)	\$ 4,625	\$ (74)
Collateralized mortgage obligations .....	-	-	2,983	(85)
Corporate bonds .....	7,321	(239)	-	-
Total .....	<u>\$ 15,983</u>	<u>\$ (360)</u>	<u>\$ 7,608</u>	<u>\$ (159)</u>

At December 31, 2008, 21 debt securities with unrealized losses have depreciated 16.3% from their amortized cost basis. The vast majority of these securities are rated AAA by the major rating agencies and are highly liquid. The Bank has analyzed the unrealized loss positions for the state municipal and mortgage backed securities and corporate bonds and has determined that the decline in value is temporary and is related to the change in market interest rates since purchase and illiquidity in the marketplace and not to the deterioration in the creditworthiness of the issuers. Also, management has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.

The unrealized loss related to the collateralized debt obligations are temporary and were substantially related to the widening credit spreads and general lack of liquidity in the market place, accordingly that Bank does believe this loss is other than temporary impairment. The Bank does not expect any change of cash flows from these securities than was originally anticipated, and the Bank has the intent and ability to hold these investments for a reasonable period of time for a forecasted recovery of fair value up to (or beyond) the cost of these investments.

### **NOTE 3: RELATED-PARTY TRANSACTIONS**

In the ordinary course of business, the Bank has granted loans to certain directors, officers and employees, and the companies with which they are associated. All such loans were made under terms consistent with the Bank's normal lending policies. As of December 31, 2008, the Bank had outstanding loans to officers totaling \$439,000. The Bank did not have loans to officers nor to employees as of December 31, 2007. Loan commitments outstanding to directors totaled \$450,000 for 2008 and 2007, while outstanding loans to directors amounted to \$231,000 and \$187,000, for 2008 and 2007, respectively.

Deposits from related parties and affiliates held by the Bank at December 31, 2008 and 2007 amounted to \$3.2 million and \$3.3 million, respectively.

In 2006, the Bank and a shareholder who owns a controlling interest of the Bank executed an arms-length participation agreement where the purchase of an investment corporate security in the amount of \$5.4 million at the time of the purchase is being participated between the Bank and major shareholder. Under the terms of the agreement, the Bank owns 94.5% and major shareholder owns 5.5% of the security. The investment security bears an interest rate of 8.85% and has a maturity date of February 15, 2027. At December 31, 2008, the amortized cost basis of the security is \$5.1 million.

### **NOTE 4: LOANS**

A summary of loans is as follows at December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Commercial loans not secured by real estate.....	\$ 54,327	\$ 63,521
Real estate mortgage loans .....	93,183	63,977
Real estate construction loans.....	9,578	20,427
Personal loans not secured by real estate.....	1,966	1,782
Unearned income, premiums, discounts and fees.....	(62)	(103)
Total .....	<u>\$ 158,992</u>	<u>\$ 149,604</u>

In accordance with management's credit administration policy, loans are placed on nonaccrual status when the full collection of interest and principal is uncertain. At December 31, 2008 and 2007, loans on nonaccrual status totaled \$5.1 and \$1.3 million, respectively. If nonaccrual loans had continued to accrue interest in accordance with their original terms, approximately \$328,000 and \$45,000 of additional interest income would have been recognized in 2008 and 2007, respectively.

Loans 90 days or more past due as to interest and/or principal, which are not on nonaccrual status, totaled approximated \$2.9 million at December 31, 2007. At December 31, 2008, the Bank did not have loans that were 90 days past due.

A summary of impaired loans is as follows at December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Impaired loans with specific reserves.....	\$ 5,106	\$ 5,257
Allowance for loan losses.....	(81)	(554)
Carrying value of impaired loans .....	<u>\$ 5,025</u>	<u>\$ 4,703</u>

In accordance with the Bank's policy, if full collection of principal on impaired loans is uncertain, cash receipts will be applied first to principal, then to interest income. During 2008 and 2007 the Bank had an average investment in impaired loans of approximately \$4,200,000 and \$367,000, respectively.

At December 31, 2008 and 2007, the Bank serviced loans for others totaling \$4.1 million and \$6.2 million, respectively. All of these loans are the portion of participation loans sold to others are therefore not included in the accompanying consolidated balance sheets.

Loans totaling \$2.3 million and \$2.4 million at December 31, 2008 and 2007 were pledged as collateral with the Federal Reserve Bank to secure purchases of Federal funds.

Loans totaling \$30 million and \$12.9 million at December 31, 2008 and 2007, respectively, were pledged as collateral with the Federal Home Loan Bank of San Francisco to secure term and overnight advances.

**NOTE 5: ALLOWANCE FOR LOAN LOSSES**

A summary of activity in the allowance for loan losses is as follows for the years ended December 31 (dollars in thousands):

	2008	2007
Balance: beginning of period.....	\$ 2,438	\$ 2,351
Loans charged off.....	(459)	(125)
Recoveries of loans previously charged off.....	-	212
Provision for loan losses.....	192	-
Balance: end of period.....	\$ 2,171	\$ 2,438

**NOTE 6: PREMISES AND EQUIPMENT**

A summary of premises and equipment is as follows at December 31 (dollars in thousands):

	2008	2007
Furniture, fixtures and equipment .....	\$ 3,690	\$ 3,690
Leasehold improvements.....	761	761
Total .....	4,451	4,451
Accumulated depreciation and amortization .....	(4,144)	(3,813)
Net.....	\$ 307	\$ 638

**NOTE 7: DEPOSITS**

The following table summarizes the average outstanding balance of deposits and average rates paid thereon for the periods indicated (dollars in thousands):

	As of December 31, 2008		As of December 31, 2007	
	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate
Demand deposits				
Noninterest-bearing .....	\$ 99,892	0.00 %	\$ 124,738	0.00 %
Interest bearing .....	116,297	1.40	115,408	1.75
Savings deposits.....	2,972	0.37	2,742	0.58
Time deposits.....	13,978	3.11	14,894	3.79
Total.....	\$ 233,139	0.89 %	\$ 257,782	1.01 %

At December 31, 2008, the Bank had \$10.9 million in domestic interest bearing time deposits of which \$5.5 million exceeded \$100,000. Maturity information for all domestic interest bearing time deposits is summarized below for the dates indicated (dollars in thousands):

	As of December 31, 2008		As of December 31, 2007	
	Under \$100	Over \$100	Under \$100	Over \$100
1 to 90 days.....	\$ 1,966	2,201	\$ 1,474	\$ 2,361
91 to 180 days.....	1,386	1,659	1,452	3,339
181 days to one year .....	1,569	1,342	1,626	4,961
Over 1 year to 5 years.....	506	286	495	364
Total.....	<u>\$ 5,427</u>	<u>5,488</u>	<u>\$ 5,047</u>	<u>\$ 11,025</u>

**NOTE 8: FHLB ADVANCES AND OTHER BORROWINGS**

At December 31, 2008 and 2007, the Bank had \$40.4 and \$5.4 million in FHLB advances outstanding, which bear a fixed weighted-average interest rate of 3.18% and 4.38%. The Bank had available lines of credit totaling \$100.2 million and \$89.7 million at December 31, 2008 and 2007 with the FHLB, Federal Reserve Bank (“FRB”) and other financial institutions. The FHLB advances are collateralized by commercial mortgage loans, qualifying investment securities and FHLB stock. Average balances of FHLB advances for 2008 and 2007 amounted to \$35.4 million and \$5.4 million, respectively, while the maximum FHLB outstanding at any month-end during 2008 and 2007 totaled \$49.1 million and \$5.4 million, respectively.

At December 31, 2008, the aggregate FHLB advances maturities, were (dollars in thousands):

	Amount
Within one year .....	\$ 5,375
After one year through three years .....	25,000
After three years through five years .....	10,000
Total .....	<u>\$ 40,375</u>

**NOTE 9: SHAREHOLDERS’ EQUITY**

On November 29, 2004, the Bank shareholders approved a one for thirty reverse stock split of the Bank 's common stock. Under the terms of the stock split, fractional shares will not be issued after the effective date of the split. As a result, approximately \$3.2 million will be paid out to shareholders with fractional shares. At December 31, 2008, \$0.4 million was still outstanding for payment of fractional shares.

On September 18, 2007, the board of directors of the Bank authorized the repurchase of its common stock up to \$7.7 million over a one-year period ending on September 18, 2008. This period was subsequently extended through September 18, 2009. Under this program, the Bank has repurchased 124 shares for approximately \$0.3 million.

**NOTE 10: INCOME TAXES**

The Bank is subject to federal income tax and income tax of the state of California. Federal income tax returns for the years ended December 31, 2007, 2006, and 2005 are open to audit by the federal authorities and California state tax returns for the years ended December 31, 2007, 2006, 2005, and 2004 are open to audit by state authorities.

The current and deferred taxes for the Bank are as follows for the years ended December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Current taxes		
Federal.....	\$ 293	\$ 278
State.....	358	227
Total .....	<u>651</u>	<u>505</u>
Deferred taxes.....	(1,094)	146
Income taxes.....	<u>\$ (443)</u>	<u>\$ 651</u>

In connection with a merger in 2002, the Bank acquired \$6.0 million of Federal net operating loss carryforwards generated by its former parent company, which resulted in \$2.0 million of tax benefits. The net operating loss carryforwards began expiring in 2005 and expire through 2019. Utilization of the losses is limited to approximately \$0.9 million per year. As of December 31, 2008, the Bank has fully utilized the net operating loss carryforwards benefits. During 2008 and 2007, the Bank recognized current tax benefits of \$0.3 million related to these net-operating losses.

The actual income tax expense differed from the expected Federal statutory rate as follows for the years ended December 31, (dollars in thousands):

	<u>2008</u>		<u>2007</u>	
	Amount	%	Amount	%
Expected tax expenses at 34% .....	\$ 109	34.0 %	\$ 999	34.0 %
Net state franchise (benefit) tax .....	(22)	(6.8)	168	5.7
Tax-free interest income .....	(380)	(118.4)	(319)	(10.9)
Interest on bank-owned-life-insurance .....	(155)	(48.3)	(144)	(4.9)
Other .....	5	1.4	(53)	(1.8)
Total .....	<u>\$ (443)</u>	<u>(138.1)%</u>	<u>\$ 651</u>	<u>22.1 %</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities are as follows at December 31 (dollars in thousands):

	<u>2008</u>	<u>2007</u>
Deferred Tax Assets		
Net operating loss carryforwards.....	\$ -	\$ 250
Write-downs on investment securities.....	1,291	-
Alternative minimum tax carryforwards .....	136	140
Expense accruals and other .....	682	668
Deferred state income taxes .....	122	91
Total gross deferred tax assets .....	<u>2,231</u>	<u>1,149</u>
Deferred tax liabilities		
Loans, allowance for loan losses, deferred fees and costs.....	(869)	(889)
Expenses and other.....	(174)	(166)
Unrealized gains on AFS securities.....	(376)	(431)
Total gross deferred tax (liabilities) .....	<u>(1,419)</u>	<u>(1,486)</u>
Net deferred tax asset (liabilities).....	<u>\$ 812</u>	<u>\$ (337)</u>

**NOTE 11: FAIR VALUE MEASUREMENT**

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

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

In certain cases where there is limited activity or less transparency for inputs to the valuation, securities are classified in Level 3 of the valuation hierarchy. For instance, in the valuation of certain collateralized mortgage and debt obligations and high-yield debt securities, the determination of fair value may require benchmarking to similar instruments or analyzing default and recovery rates. For trust-preferred collateralized debt obligations ("CDOs"), the Bank obtained price information from third-party dealer quotes, as this level of evidence is the strongest support absent current market activity for the fair value of these securities. Therefore, the CDO securities were classified in Level 2 of the valuation hierarchy.

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

The following table provides the hierarchy and fair value for each major category of assets and liabilities measured at fair value at December 31, 2008 (dollars in thousands):

	Fair Value Measurement using			Total
	Level 1	Level 2	Level 3	
Assets and liabilities measured at fair value on a recurring basis				
Assets:				
Securities available for sale .....	\$ 84,483	\$ 35,466	\$ -	\$ 119,949
Assets and liabilities measured at fair value on a nonrecurring basis				
Assets:				
Collateral-dependent impaired loans, net of reserves.....			\$ 5,025	\$ 5,025

Collateral-dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying value of \$5,106,000, with a specific reserve of \$81,000.

## **NOTE 12: DISCLOSURES ABOUT THE FAIR VALUE OF FINANCIAL INSTRUMENTS**

Fair value estimates of financial instruments for both assets and liabilities are made at a discrete point in time based on relevant market information and information about the financial instruments. Because no active market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments, prepayment assumptions, future expected loss experience and other such factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The Bank intends to hold the majority of its assets and liabilities to their stated maturities. Thus, management does not believe that the bulk sale concepts applied to certain problem loans for purposes of measuring the impact of credit risk on fair values of said assets is reasonable to the operations of the Bank and does not fairly present the values realizable over the long term on assets that will be retained by the Bank. Therefore, the Bank does not intend to realize any significant differences between carrying balance and fair value disclosures through sale or other disposition. No attempt should be made to adjust shareholders' equity to reflect the following fair value disclosures, as management believes them to be inconsistent with the philosophies and operations of the Bank.

In addition, the fair value estimates are based on existing on-and-off-balance sheet financial instruments without attempting to estimate the value of existing and anticipated future customer relationships and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include the branch network, deferred tax assets and premises and equipment.

Fair value estimates, methods, and assumptions are set forth below:

**CASH, INTEREST-BEARING DEPOSITS WITH FINANCIAL INSTITUTIONS AND FEDERAL FUNDS:** The carrying values approximate fair value because of the short-term maturity of these instruments.

**INVESTMENT SECURITIES:** See fair market measurement footnote number 11.

**LOANS:** For loans, fair value is estimated using quoted market prices for similar loans. For loans for which no quoted market price is readily available, fair value is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same maturities.

**DEPOSIT LIABILITIES:** The fair value of demand, savings and money market deposits is the amount payable on demand at the reporting date. The fair value of time certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

**OTHER INTEREST-BEARING LIABILITIES:** Other interest-bearing liabilities include other borrowed funds and Federal Home Loan Bank borrowings. The fair value of other interest-bearing liabilities is estimated using market rates for instruments with similar characteristics.

**COMMITMENTS TO EXTEND CREDIT:** The fair value of commitments to extend credit cannot be readily determined.

The estimated fair values of financial instruments are as follows (dollars in thousands):

	As of December 31, 2008		As of December 31, 2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial Assets:</b>				
Cash and cash equivalents .....	\$ 22,820	\$ 22,820	\$ 47,028	\$ 47,028
FHLB Stock.....	2,276	2,276	1,164	1,164
Investment securities .....	119,949	119,949	91,958	91,958
Net loans.....	156,821	158,975	147,166	147,280
<b>Financial Liabilities:</b>				
Deposits .....	232,471	232,499	252,337	252,406
FHLB Advances .....	40,375	40,375	5,375	5,375

**NOTE 13: 401(k) PROFIT SHARING PLAN**

The Bank’s employees may participate in the Bank’s 401(k) profit sharing plan (the “401k Plan”) that covers all employees eighteen years of age or older who have completed three months of employment. Each employee eligible to participate in the 401k Plan may contribute up to 100% of his or her compensation, subject to certain statutory limitations. Eligible employees have the option on a quarterly basis to change the status of their enrollment and/or the amount of their deferral. The Bank currently matches 50% of the participant’s contribution up to 6% of employee compensation, which is subject to the 401k’s plan’s vesting schedule. The Bank’s contributions for 2008 and 2007 totaled \$113,000 and \$107,000, respectively and are included in salaries and employee benefits during both periods. The Bank may also make an additional profit sharing contribution on behalf of eligible employees. No profit sharing contributions were made during 2008 and 2007.

**NOTE 14: STOCK OPTION PLAN**

In 2001, the Board of Directors of the Bank approved a stock option plan (“the Plan”). The Plan provides for future grants of options to employees and directors of the Bank for the purchase of up to 3,333 shares of the Bank’s common stock. The options, when granted, vest ratably over one to five years from the grant date and expire after ten years if not exercised. The plan also provides for accelerated vesting should a change in control occur. Option prices are the fair market value of the underlying stock as of the grant date. The Bank recognized stock-based compensation cost of \$0.01 million during 2008 and 2007. The income tax benefit for 2008 and 2007 was immaterial.

The fair value of the each option was estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2008	2007
Expected Volatility .....	15.00%	15.00%
Expected Term .....	7.0 Years	7.2 Years
Expected Dividends .....	None	None
Risk Free Rate .....	3.57%	4.83%
Weighted-Average Grant Fair Value.....	\$ 477.00	\$ 853.00

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

The following table summarizes the activity in the Plan during 2008:

	Options Granted	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value in Thousands
Balance: January 1, 2008 .....	844	\$ 4,007.50		
Options granted.....	112	1,732.50		
Options exercised.....	-	-		
Options forfeited.....	(29)	3,144.84		
Balance: December 31, 2008 .....	<u>927</u>	<u>\$ 3,760.05</u>	<u>6.88</u>	<u>\$</u>
Options exercisable.....	<u>684</u>	<u>\$ 4,256.50</u>	<u>6.80</u>	<u>\$</u>

The following table summarizes the activity in the Plan during 2007:

	Options Granted	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value in Thousands
Balance: January 1, 2007 .....	809	\$ 4,102.99		
Options granted.....	119	2,643.24		
Options exercised.....	(2)	1,778.95		
Options forfeited.....	(82)	3,047.91		
Balance: December 31, 2007 .....	<u>844</u>	<u>\$ 4,007.50</u>	<u>8.86</u>	<u>\$ -</u>
Options exercisable.....	<u>640</u>	<u>\$ 4,344.67</u>	<u>8.67</u>	<u>\$ -</u>

As of December 31, 2008, there was \$0.2 million of total unrecognized compensation cost related to the outstanding stock options that will be recognized through October 2012.

The following is a summary of the status of the Bank's nonvested shares of grants as of December 31, 2008:

Nonvested Shares	Shares	Weighted Average Grant- Date Fair Value
Nonvested: January 1, 2008 .....	44	\$ 3,682.95
Granted .....		
Vested .....	(10)	3,625.00
Forfeited .....	(34)	3,700.00
Nonvested: December 31, 2008 .....	<u>-</u>	<u>\$ -</u>

The following is a summary of the status of the Bank's nonvested shares of grants as of December 31, 2007:

Nonvested Shares	Shares	Weighted Average Grant- Date Fair Value
Nonvested: January 1, 2007 .....	54	\$ 3,672.22
Granted .....	-	-
Vested .....	(10)	3,625.00
Forfeited .....	-	-
Nonvested: December 31, 2007 .....	<u>44</u>	<u>\$ 3,682.95</u>

#### **NOTE 15: COMMITMENTS AND CONTINGENCIES**

##### **LEASES**

The Bank leases certain facilities for corporate offices and branch operations and leases equipment under non-cancelable long-term operating leases. Gross facility lease expense for the years ended December 31, 2008 and 2007 was \$1.2 million for each year.

Under the lease agreement for the Tustin facility, the Bank has obtained a letter of credit from the FHLB for the benefit of the lessor in the amount of \$0.2 million as a security deposit.

During 2007, the Bank entered into a non-cancelable sub-lease agreement where a portion of its Tustin facilities is being rented to a third party. A total of \$0.01 million in rental income was recognized in 2008 and 2007. Because the lease was negotiated at a below market price, the Bank recognized a loss on the sub-lease agreement of approximately \$0.01 million in 2007. Under the terms of the sub-lease agreement future rental income of approximately \$0.2 million is expected to be realized through July 2011.

Future minimum lease commitments under all non-cancelable operating leases at December 31, 2008 are as follows (dollars in thousands):

Year Ending December 31,	
2009 .....	\$ 1,246
2010 .....	1,201
2011 .....	559
Total minimum lease payments .....	<u>\$ 3,006</u>

## *FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK*

In the normal course of business, the Bank is a party to financial instruments with off-balance sheet risk to meet the financing needs of customers and to reduce exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby and commercial letters of credit. At December 31, 2008 and 2007, the Bank had standby and commercial letters of credit of \$0.1 million and \$1.0 million outstanding and commitments to extend credit, totaling \$27.5 million and \$31.3 million, respectively.

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. Standby and commercial letters of credit and financial guarantees written are conditional commitments issued by the Bank to guaranty the performance of a customer to a third party. 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 credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counter-party. Collateral held varies but may include deposits, accounts receivable, inventory, property, plant and equipment, motor vehicles and real estate.

## *LITIGATION*

From time to time, the Bank may become party to various lawsuits, which have arisen in the course of business. While it is not possible to predict with certainty the outcome of such litigation, it is the opinion of management, based in part upon opinions of counsel, that the liability, if any, arising from such lawsuits would not have a material adverse effect on the Bank's financial position or results of operations.

## ***NOTE 16: REGULATORY MATTERS***

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

Quantitative measures established by the regulators to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2008 and 2007 that the Bank met all capital adequacy requirements.

As of December 31, 2008 and 2007, the Bank was categorized as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since the last notification that management believes have changed the institution's category. The Bank's actual capital amounts and ratios are also presented in the following table (dollars in thousands):

	Actual		For Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2008</u>						
Tier 1 leverage ratio.....	\$ 38,493	12.68%	\$ 12,145	4.00%	\$ 15,181	5.00%
Tier 1 risk-based capital ratio....	38,493	19.01	8,099	4.00	12,149	6.00
Total risk based capital ratio.....	40,789	20.14	16,199	8.00	20,249	10.00
<u>As of December 31, 2007</u>						
Tier 1 leverage ratio.....	\$ 37,605	12.33%	\$ 12,198	4.00%	\$ 15,247	5.00%
Tier 1 risk-based capital ratio....	37,605	18.40	8,174	4.00	12,261	6.00
Total risk based capital ratio.....	40,160	19.65	16,348	8.00	20,436	10.00

#### *DIVIDEND RESTRICTIONS*

Various laws and regulations limit the amount of dividends that a bank can pay without obtaining prior approval from bank regulators. During the year ended December 31, 2008, the Bank did not pay any dividends. At December 31, 2008, the Bank may pay dividends of \$4.6 million without prior regulatory approval.